Co-Chairs' Report on Testimony Taken on Maximizing Ohio's Competitiveness, Flat Rate Income Tax, Tax Credits, and Other Tax Related Topics

October 1, 2017

Presented by the Co-Chairs of the 2020 Tax Policy Study Commission

Senator Bob Peterson |Representative Tim Schaffer

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Introduction

The 2020 Tax Policy Study Commission was created in 2015 by House Bill 64. In addition to a review of the state's severance tax and a study of the Ohio Historic Preservation Tax Credit, the Commission was tasked with studying Ohio's tax structure and policies and the potential of a transition to a flat income tax rate, and then to publish its findings and recommendations in a report to the General Assembly no later than October 1, 2017.

Previously, this Commission has submitted two other reports for the General Assembly's consideration. The first of which was released on October 22, 2015 as a review of the state's severance tax policy and the oil and gas industry. The second report was released on October 31, 2016 and studied the Ohio Historic Preservation Tax Credit and its impacts.

The Commission held ten public hearings over one year's time, hearing from forty three individuals from the executive branch of state government, the world of academia, and business owners and industry leaders. These testifiers summarized both successes and flaws in Ohio's taxation policies, and they highlighted potential solutions and posited theories about Ohio's economic future.

Commission Members

The following individuals have attended and have been members of the 2020 Tax Policy Study Commission as it reviewed Ohio's tax structure:

- Senator Bob Peterson (Co-Chair)
- Representative Tim Schaffer (Co-Chair)
- Representative Jeff McClain (As Co-Chair)
- Representative Jack Cera
- Representative Kirk Schuring
- Director Tim Keen, Office of Budget Management
- Senator Scott Oelslager
- Senator Charleta Tavares

R-132-1842

OHIO LEGISLATIVE SERVICE COMMISSION

Research Memorandum

Mackenzie Damon
September 25, 2017

OVERVIEW OF THE OHIO INCOME TAX

SUMMARY

This memorandum provides an overview of the Ohio personal income tax and includes information on the income tax base, tax rates, the deductions and credits available against the tax, and the use of income tax revenue. Also included is some brief information on the income taxes of other states.

Ohio personal income tax

Background

The Ohio individual income tax was enacted in 1971. When the tax first took effect on January 1, 1972, the tax applied to individuals and estates. In 2002, the tax was expanded to apply to some trusts. The accompanying "Individual Income Tax" chapter of the Ohio Department of Taxation's 2016 Annual Report includes a history of major changes to the tax since 1972. This memorandum also includes a history of income tax rates since 1980 and some background on changes in the number of deductions and credits allowed against the tax.

Tax base

For individuals, the income tax uses a taxpayer's federal adjusted gross income (FAGI) as the beginning figure to determine the taxpayer's tax liability. Specific additions and deductions are then added to or deducted from FAGI to arrive at Ohio adjusted gross income (OAGI). From OAGI personal exemptions are subtracted, and the result is taxable income. Taxable income is multiplied by the applicable tax rate, resulting in a taxpayer's gross tax liability. From this gross liability, tax credits are then subtracted.

For trusts and estates, the tax base is federal taxable income after several additions and deductions.

The income tax applies to residents, and to nonresidents who have income from working, from owning or operating a business in Ohio, or from other income sources in Ohio. For residents who have income taxable by another state with an income tax, a credit is available to offset the tax paid to other states at least in part; for nonresidents who have income attributable to Ohio and another state, a credit is allowed to the extent the income is not attributable to Ohio.

Tax rates

The following table presents a history of the state's income tax rates. Since 1983, the General Assembly has reduced statutory income tax rates four times (not counting one acceleration of a previously enacted reduction). Between 1984 and 1988, the General Assembly reduced rates by almost 22%.[1] Then, in 2005, the General Assembly enacted legislation to further reduce rates by 21% over five years, with reductions of 4.2% per year. The first four of these reductions applied to the 2005 through 2008 taxable years; the fifth reduction, initially scheduled for the 2009 taxable year, was postponed to 2011.[2]

In 2013, the General Assembly enacted H.B. 59, which provided for rate reductions of 8.5% for the 2013 taxable year, 9% for the 2014 taxable year, and 10% for the 2015 taxable year and thereafter (all percentages compared to the 2012 rates). Then, in 2014, the General Assembly accelerated the third and final H.B. 59 reduction, such that the full 10% reduction applied to the 2014 taxable year.[3]

In 2015, the General Assembly established separate tax brackets for business and nonbusiness income. H.B. 64 maintained the existing nine-tiered tax brackets for nonbusiness income, while reducing the tax rates for those brackets by 6.3% for the 2015 taxable year and thereafter. With respect to business income, a 3% flat tax is now applied to all income in excess of the business income deduction. (See "**Additions, deductions, and credits**," below, for a discussion of the business income deduction.)

The General Assembly reduced the number of income tax brackets applicable to nonbusiness income in 2017, through the repeal of the bottom two brackets ($0-$5,000 and $5,000-$10,000). This bracket reduction will have no practical effect for most taxpayers, since, previously, most taxpayers with an Ohio adjusted gross income of $10,000 or less did not owe any tax due to the operation of a low-income taxpayer credit. Beginning in 2017, this credit is eliminated, and the new lowest tax bracket begins at $10,001, rather than $0.[4]

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[1] H.B. 291 of the 115th General Assembly; H.B. 238 of the 116th General Assembly; S.B. 111 of the 117th General Assembly.

[2] H.B. 66 of the 126th General Assembly; H.B. 318 of the 128th General Assembly.

[3] Am. Sub. H.B. 483 of the 130th General Assembly.

[4] Although the first two brackets will no longer exist, when a taxpayer has an OAGI of more than $10,000, there is still tax due on that first $10,000. That amount is $77.97 – the amount that would be due if

In the following table, note that the rates for 1996 through 2000 include reductions that resulted from the operation of the Income Tax Reduction Fund (not from statutory changes).

Tax Year	Tax Brackets								
	$5,000 or less	$5,000 to $10,000	$10,000 to $15,000	$15,000 to $20,000	$20,000 to $40,000	$40,000 or more			
1980	0.5%	1%	2%	2.5%	3%	3.5%			
1981	0.5%	1%	2%	2.5%	3%	3.5%			
	$5,000 or less	**$5,000 to $10,000**	**$10,000 to $15,000**	**$15,000 to $20,000**	**$20,000 to $40,000**	**$40,000 to $80,000**	**$80,000 to $100,000**	**$100,000 or more**	
1982	0.625%	1.25%	2.5%	3.125%	3.75%	4.375%	5%	6.25%	
1983	0.9165%	1.833%	3.666%	4.5825%	5.499%	6.4155%	7.332%	9.165%	
1984	0.95%	1.9%	3.8%	4.75%	5.7%	6.65%	7.6%	9.5%	
1985	0.903%	1.805%	3.610%	4.513%	5.415%	6.318%	7.220%	9.025%	
1986	0.855%	1.71%	3.42%	4.275%	5.13%	5.985%	6.84%	8.55%	
1987	0.751%	1.502%	3.004%	3.755%	4.506%	5.257%	6.008%	6.9%	
1988	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	
1989	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	
1990	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	
1991	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	
1992	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	
	$5,000 or less	**$5,000 to $10,000**	**$10,000 to $15,000**	**$15,000 to $20,000**	**$20,000 to $40,000**	**$40,000 to $80,000**	**$80,000 to $100,000**	**$100,000 to $200,000**	**$200,000 or more**
1993	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	7.5%
1994	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	7.5%
1995	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	7.5%
1996	0.693%	1.387%	2.775%	3.469%	4.162%	4.857%	5.550%	6.444%	7.004%
1997	0.713%	1.426%	2.853%	3.566%	4.279%	4.993%	5.706%	6.624%	7.201%
$5,000 or less	**$5,000 to $10,000**	**$10,000 to $15,000**	**$15,000 to $20,000**	**$20,000 to $40,000**	**$40,000 to $80,000**	**$80,000 to $100,000**	**$100,000 to $200,000**	**$200,000 or more**	**$5,000 or less**
1998	0.673%	1.347%	2.694%	3.368%	4.040%	4.715%	5.388%	6.255%	6.799%
1999	0.716%	1.432%	2.864%	3.580%	4.295%	5.012%	5.727%	6.650%	7.228%

TY 2016's first two (inflation-adjusted) brackets were still in effect (0.495% of $5,250 plus 0.990% of the next $5,250 = $77.97).

Tax Year	Tax Brackets								
$5,000 or less	**$5,000 to $10,000**	**$10,000 to $15,000**	**$15,000 to $20,000**	**$20,000 to $40,000**	**$40,000 to $80,000**	**$80,000 to $100,000**	**$100,000 to $200,000**	**$200,000 or more**	**$5,000 or less**
2000	0.691%	1.383%	2.766%	3.458%	4.148%	4.841%	5.531%	6.422%	6.980%
2001	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	7.5%
2002	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	7.5%
2003	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	7.5%
2004	0.743%	1.486%	2.972%	3.715%	4.457%	5.201%	5.943%	6.9%	7.5%
2005	0.712%	1.424%	2.847%	3.559%	4.270%	4.983%	5.693%	6.61%	7.185%
2006	0.681%	1.361%	2.722%	3.403%	4.083%	4.764%	5.444%	6.32%	6.87%
2007	0.649%	1.299%	2.598%	3.247%	3.895%	4.546%	5.194%	6.031%	6.555%
2008	0.618%	1.236%	2.473%	3.091%	3.708%	4.327%	4.945%	5.741%	6.24%
2009	0.618%	1.236%	2.473%	3.091%	3.708%	4.327%	4.945%	5.741%	6.24%
	$5,050 or less	**$5,050 to $10,100**	**$10,100 to $15,150**	**$15,150 to $20,200**	**$20,200 to $40,350**	**$40,350 to $80,700**	**$80,700 to $100,900**	**$100,900 to $201,800**	**$201,800 or more**
2010	0.618%	1.236%	2.473%	3.091%	3.708%	4.327%	4.945%	5.741%	6.24%
	$5,100 or less	**$5,100 to $10,200**	**$10,200 to $15,350**	**$15,350 to $20,450**	**$20,450 to $40,850**	**$40,850 to $81,650**	**$81,650 to $102,100**	**$102,100 to $204,200**	**$204,200 or more**
2011	0.587%	1.174%	2.348%	2.935%	3.521%	4.109%	4.695%	5.451%	5.925%
	$5,200 or less	**$5,200 to $10,400**	**$10,400 to $15,650**	**$15,650 to $20,900**	**$20,900 to $41,700**	**$41,700 to $83,350**	**$83,350 to $104,250**	**$104,250 to $208,500**	**$208,500 or more**
2012	0.587%	1.174%	2.348%	2.935%	3.521%	4.109%	4.695%	5.451%	5.925%
2013	0.537%	1.074%	2.148%	2.686%	3.222%	3.760%	4.296%	4.988%	5.421%
2014	0.528%	1.057%	2.113%	2.642%	3.169%	3.698%	4.226%	4.906%	5.333%
2015	0.495%	0.990%	1.980%	2.476%	2.969%	3.465%	3.960%	4.597%	4.997%
	$5,250 or less	**$5,250 to $10,500**	**$10,500 to $15,800**	**$15,800 to $21,100**	**$21,100 to $42,000**	**$42,000 to $84,200**	**$84,200 to $105,300**	**$105,300 to $210,660**	**$210,600 or more**
2016	0.495%	0.990%	1.980%	2.476%	2.969%	3.465%	3.960%	4.597%	4.997%
2017[5]			1.980%[6]	2.476%	2.969%	3.465%	3.960%	4.597%	4.997%

[5] At the time of writing, the Department of Taxation had not published the inflation-adjusted income brackets for tax year 2017.

[6] See footnote 4.

Additions, deductions, and credits

OAGI is computed by adding or subtracting various additions and deductions to or from FAGI. Currently, there are nine additions and 24 deductions from FAGI. The number of additions and deductions has increased over the years. From 1973 through 1980, two additions and five deductions were required. Additions rose thereafter to three as of 1988, to eight as of 2000, and to nine currently. The number of deductions remained the same until 1988. Thereafter, deductions rose to eight as of 1995, to 14 as of 2000, to 21 as of 2010, and to 24 as of today.

Tax credits are subtracted from a taxpayer's gross liability to result in net tax liability. Currently, there are 10 nonbusiness credits (including the credit for joint filers). There are 15 business credits, nine of which are nonrefundable and six of which are refundable. The number of credits available has also gradually increased since the introduction of the tax, from five tax credits in 1973 to six as of 1980, 11 as of 1991, 30 as of 2000, and 25 as of today.[7]

The accompanying Tax Expenditure Report for FY 2017-2018 enumerates, on pages 26-33, the deductions and credits allowed against the income tax, their estimated revenue impact, and the year in which each was originally enacted.

Business income deduction

In recent years, the most significant change in the area of tax deductions and credits has been the addition of the business income deduction. The deduction was enacted in 2013. For the 2013 taxable year, the deduction equaled 50% of a taxpayer's business income, up to $125,000 per year (or $62,500 for spouses filing separate returns). H.B. 483 of the 130th General Assembly temporarily increased the deduction to 75% of a taxpayer's first $250,000 of business income for the 2014 taxable year. For that taxable year, the tax rates applicable to any remaining income were identical to the rates applicable to nonbusiness income. In 2015, H.B. 64 continued the 75% deduction for the 2015 taxable year, but subjected an individual's remaining business income to the 3% flat tax. Then, beginning in 2016, the deduction increased to 100% of the first $250,000 of a taxpayer's business income (or $125,000 for spouses filing separate returns), with any excess business income subject to the 3% flat tax.

[7] The number of additions, deductions, and tax credits cited in this memorandum is based upon the number of separate lines dedicated to additions, deductions, and tax credits on the 2016 IT-1040 and its associated schedules, excluding the low-income taxpayer credit. The number does not include the personal and dependent exemption or the resident/nonresident credits.

Tax revenue

The following chart provides figures for total income tax collections in fiscal years 2010 through 2016.[8]

Fiscal Year	Income Tax Revenue (in millions)
2010	$7,886.8
2011	$8,820.0
2012	$9,029.7
2013	$9,869.8
2014	$8,425.1
AQ	$8,883.2
2016	$8,169.2

Around 95.7% of the state's income tax revenue is deposited in the General Revenue Fund (GRF). The Ohio Constitution requires that at least 50% of income tax collections must be returned to the county of origin. This requirement is met primarily through GRF allocations to education, Local Government Fund distributions, and property tax relief (such as the homestead exemption).

Comparison with other states

As of January 1, 2017, 41 states levy a general income tax, two states levy a tax only on dividends and interest income, and seven states have no income tax. Of the 41 states with a general income tax, 33 have a graduated tax rate structure, while eight levy a flat rate tax (with rates ranging from 3.07% to 5.499%).

The Federation of Tax Administrators has compiled a report that includes information on the tax brackets and rates of each state, as of January 1, 2017. The chart is available at: https://www.taxadmin.org/assets/docs/Research/Rates/ind_inc.pdf.

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[8] This chart is compiled from data in the "Individual Income Tax" chapters of the Ohio Department of Taxation's 2014, 2015, and 2016 Annual Reports, available at: http://www.tax.ohio.gov/communications/publications.aspx.

Ohio 2020 Tax Policy Commission

Testimony of Tax Commissioner Joe Testa
Department of Taxation
October 22, 2015

Co-Chairman Senator Peterson, Co-Chairman Representative McClain, and members of the Tax Policy Commission, my name is Joe Testa, and I am Tax Commissioner for the Department of Taxation.

I was asked to testify before you today on Ohio's tax system and the revenues generated from those taxes. I will mostly be testifying on those taxes administered by the Department of Taxation and that directly contribute to state revenues.

I will also be briefly addressing those local taxes which the department administers including the school district income tax, the lodging and resort area taxes, and the public utility property tax.

Most of the taxes I'll be discussing are directed in whole or in part to the state general revenue fund, or GRF. I'm sure all of you are familiar with the state's major GRF taxes: the sales and use taxes, individual income tax, cigarette tax and commercial activity tax. These generate approximately 91 percent of all general fund revenues excluding federal aid. A handful of other taxes contribute about six percent of total general revenue funds and the remaining 3 percent comes from non-tax revenues, primarily licenses and fees.

I'll be presenting this brief synopsis of taxes in alphabetical order, followed by a listing and description of local taxes. For a condensed summary, please see Appendix A which is attached at the end of my written remarks. All tax revenue amounts mentioned in this testimony represent amounts collected, net of exemptions and credits.

Alcoholic Beverage Taxes

Responsibility for administering Ohio's taxes on alcoholic beverages is split between the Department of Taxation and the Department of Commerce's Division of Liquor Control.

Excise taxes on beer, wine, cider and mixed beverages, totaled approximately $57.7 million in fiscal year 2015. Of that total, approximately $1.0 million goes to the Grape Industries Fund, the rest to the General Revenue Fund. Exemptions and credits totaled $4.4 million in FY 15.

Cigarette and Other Tobacco Products Tax

Ohio has levied an excise tax on cigarettes since 1931. The current rate, $1.60 per pack, became effective July 1, 2015. The tax is paid initially by wholesale dealers who buy tax stamps that are affixed to packs of cigarettes. The cost of those stamps is included in the price of the product so the ultimate taxpayer is the person who buys cigarettes. In fiscal year 2015, state receipts totaled $808.1 million.

An excise tax on other tobacco products (OTP) – including cigars, chewing tobacco, snuff, etc., was enacted effective in 1993. The OTP tax is levied at a rate of 17 percent on the wholesale price of other tobacco products. In fiscal year 2015, total net receipts were over $62.2 million.

All tobacco taxes go to the state General Revenue Fund. Exemptions and credits totaled $14.4 million in fiscal year 2015.

Commercial Activity Tax

The commercial activity tax (CAT) is the only general business tax in Ohio. It is levied at a low rate tax of 0.26 percent on the gross receipts of most companies doing business in Ohio. The General Assembly enacted the tax in 2005 and in fiscal year 2015, total CAT revenue was about $1,751.7 million.

Effective July 1, 2015, 75 percent of CAT revenues goes to the General Revenue Fund; 20 percent goes to the School District Property Tax Replacement Fund; and 15 percent goes to the Local Government Property Tax Replacement Fund.

Manufacturers pay about 25 percent of the all CAT revenues with retailers paying the next largest share at about 20 percent. Large taxpayers, those with taxable gross receipts over $100 million, account for more than half (about 55 percent) of total CAT revenue but comprise less than one percent of the overall filer population. Taxpayers with receipts between $150,000 and $1 million pay an annual minimum tax of $150; those under $150,000 are not subject to the CAT. That group of businesses with less than $1 million in receipts makes up about 67 percent of all filers. CAT exemptions and credits totaled $576 million in FY 2015.

Estate Tax

The Ohio Estate Tax has been repealed for estates of individuals dying on or after Jan. 1, 2013. I mention it because some payments are expected to continue for the next several years. In fiscal year 2015, total estate tax collections were $17.6 million. Of that amount, the state general revenue fund share was $3.1 million and local governments got $14.5 million.

Financial Institutions Tax

The Financial Institutions Tax (FIT), for the most part, is a successor tax to the corporation franchise tax for financial institutions. Financial institutions became subject to the FIT as of January 1, 2014. Non-bank financial organizations that were subject to the commercial activities tax (CAT) also became subject to the FIT and are now excluded persons for purposes of the CAT. In fiscal year 2015, FIT revenues totaled $182.1 million. All FIT revenue goes to the state's General Revenue Fund. FIT exemptions and credits totaled $12.3 million in FY 15.

Horse Racing Tax

Ohio's horse racing tax applies to total wagers on horse races and is paid for by holders of racing permits. During fiscal year 2015, the tax generated about $5.8 million in revenue that goes for horse racing development, home health care and other services for senior citizens.

Individual Income Tax

Ohio's individual income tax traces back to 1912 when voters approved a constitutional amendment specifically authorizing the General Assembly to levy such a tax. It took sixty years for that authority to be exercised when legislative action made the tax effective Jan. 1, 1972 for individuals and estates. In 2002, the General Assembly expanded the income tax to include trusts. The individual income tax is state government's second largest source of revenue generating about 38.4 percent of total general revenue. During fiscal year 2015, net collections were slightly less than $8.9 billion. Approximately 97 percent of that money is directed to the General Revenue Fund, the remainder goes to the Local Government Fund and two smaller funds. Credits and exemptions totaled $2.15 billion in fiscal year 2015.

Insurance Premium Tax – Domestic and Foreign

The state has imposed a tax on insurance companies doing business in Ohio since the 1830s. It applies to domestic insurance companies organized under Ohio law, and foreign insurance organized outside Ohio. Both pay the same tax rate of 1.4 percent of gross premiums. Health insurance companies pay one percent. A $250 minimum tax applies. In FY 2015, total domestic insurance premium taxes were approximately $257.2 million.

In FY 2015, total foreign insurance premium taxes were approximately $287.3 million. About five percent of total collections of the insurance premium tax goes to the state's Fire Marshal Fund, the remainder to the GRF. This tax is administered by the Department of Insurance. Credits and exemptions for the insurance tax totaled $35.2 million in FY 2015.

Kilowatt-Hour Tax

The kilowatt-hour tax was created by the Ohio General Assembly in 2001 as part of a broader legislative effort to deregulate electric utilities. The kilowatt-hour tax is levied on electric distribution companies with end users in this state. The tax has tiered rates that vary according to the kilowatt-hour consumption of individual end users of electricity. In fiscal year 2015, it generated approximately $539.8 million in total revenue. Of that, 88 percent goes to the General Revenue Fund with the remainder going to the two Property Tax Replacement Funds, one for schools and the other for local governments.

Motor Vehicle Fuel and Use Tax

The motor vehicle fuel tax rate has been 28 cents per gallon since July 1, 2005. It is composed of five separate levies, each subject to a different distribution formula. The Ohio Constitution requires that gas tax revenues be used only for road construction, traffic enforcement and certain other activities.

Motor vehicle fuel wholesale dealers, rather than retailers, remit the tax. In FY 2015, net motor fuel tax collections totaled approximately $1.8 billion.

There is also a motor fuel use tax which is imposed primarily on large trucks for fuel purchased outside the state and consumed in Ohio. The use tax rate in FY 2015 was 28 cents per gallon with collections of approximately $34.9 million.

Natural Gas Distribution Tax

The natural gas distribution tax became effective July 1, 2001 with a purpose of replacing revenue lost by school districts and local governments when the assessment rate on the personal property of natural gas distribution companies was reduced from 88 to 25 percent. That changed effective July 1, 2011, when H.B. 153 directed all revenue from the tax to go to the General Revenue Fund. During fiscal year 2015, the tax generated approximately $74.7 million in total revenue.

Pass-Through Entity and Trust Withholding Tax

The pass-through entity and trust withholding tax, enacted in 1998, is not so much a separate tax as it is a mechanism designed to collect individual income tax due and payable by equity investors in qualifying pass-through entities.

A pass-through entity is an S corporation, a partnership, or a limited liability company. Qualifying pass-throughs doing business in or having nexus with Ohio are subject to the pass-through entity withholding tax. Qualifying trusts are also subject to the withholding tax. Pass-through entities not subject to this withholding tax include those whose investors are limited to full-year Ohio residents.

Data for qualifying pass-through entities showed collections totaling about $168.2 million during fiscal year 2014. FY 15 data is not yet available. All goes to the General Revenue Fund.

Petroleum Activity Tax

The petroleum activity tax (PAT) became effective July 1, 2014. It is an excise tax levied at a rate of 0.65 percent on a supplier's calculated gross receipts from the sale, transfer, exchange, or other disposition of motor fuel in this state. This tax generated $72.2 million in FY 15. More than 90 percent of that revenue went to road and highway maintenance and construction. The remainder went to the General Revenue Fund and a small administrative fund. There are credits available against the PAT but the tax is so new they haven't been fully reviewed as a tax expenditure yet.

Public Utility Excise Tax

Ohio's public utility excise tax dates back to 1894 and is a tax on gross receipts. Taxpayers include natural gas, heating, pipeline, telegraph, water transportation and water works companies. Companies liable for this excise tax do not pay the commercial activity tax. There are two tax rates: 6.75 percent for pipeline companies and 4.75 percent for all other taxpayers.

About 94 percent of the total tax is paid by natural gas companies. Total revenue collected from the public utility tax amounted to almost $97.5 million in fiscal year 2015. All of this revenue goes to the General Revenue Fund. Credits and exemptions totaled $79.5 million in FY 2015.

Replacement Tire Fee

The replacement tire fee became effective Dec. 1, 1993. Revenue from the fee is used to defray the cost of regulating scrap tire facilities, clean up accumulations of scrap tires, and provide grants and loans to support efforts to recycle scrap tires. In fiscal year 2015, approximately $7.3 million was collected and split evenly between the state's Scrap Tire Management fund and the Soil and Water Conservation District Assistance fund.

Sales and Use Tax

The sales and use tax is state government's primary source of revenue producing nearly 45% of all general revenue. It is also an important revenue source for county governments and regional transit authorities, both of which are authorized to levy "piggyback" taxes. Taxation administers both state and local taxes.

The Ohio sales and use tax dates back to 1934, when the General Assembly enacted a three percent sales tax effective January 1935. The use tax followed a year later. In 1967, county governments got authority to levy piggyback taxes, subject to repeal by local voters. In 1974, transit authorities were given the authority to levy the tax subject to voter approval.

The current state sales and use tax rate, 5.75 percent, was established on Sept. 1, 2013. During fiscal year 2015, the tax generated more than $10.1 billion in revenue. Approximately 98 percent of that amount was distributed to the General Revenue Fund. The balance was distributed to the Public Library Fund and Attorney General Claims Fund. The 56 available sales and use tax credits and exemptions totaled $5.4 billion in FY 2015.

Severance Tax

The severance tax became effective in 1972. It is paid by persons or firms that extract, or sever, certain natural resources from the soil or waters of Ohio. The tax produced $26.9 million during fiscal year 2015. Those revenues go to various dedicated funds that support geological mapping activities, land reclamation, and other regulatory efforts.

Wireless 9-1-1 Charge

The Wireless 9-1-1 charge provides state level funding for local wireless 9-1-1 service. The Department of Taxation collected about $25.6 million in fiscal year 2015. The money is deposited into the three funds: more than 95 percent goes to the wireless 9-1-1 government assistance fund; the remainder goes to the 9-1-1 program fund and the wireless 9-1-1 administrative fund.

LOCAL TAXES

Alcoholic Beverage Tax

Cuyahoga County is alone in levying this tax. It raised about $5.6 million (figure excludes tax on liquor) in FY 2015 for support of professional sports facilities and economic development activities.

Cigarette Excise Tax

Again, only Cuyahoga County is authorized to levy this tax. It brought in $18.4 million in fiscal year 2015 to support professional sports facilities and economic development in the county.

Estate Tax

As I mentioned earlier, revenues from this tax totaled $17.6 million in FY 2015. The local government share, set at 80 percent of the total, was $14.5 million.

Gross Casino Revenue Tax

The Ohio Department of Taxation administers the gross casino revenue tax. The Ohio Casino Control Commission licenses and regulates casino operators, their employees, and gaming-related vendors.

The gross casino revenue tax was enacted in 2010 and is paid by licensed casino operators at the rate of 33% of gross casino revenue. In fiscal year 2015, total collections were $266.0 million with ninety percent of that distributed locally. The remaining ten percent is split between the Casino Control and State Racing Commissions, the law enforcement training and problem gambling funds.

Municipal Income Tax for Electric Light Companies and Local Exchange Telephone Companies

This tax is paid by companies selling electricity and those providing local exchange telephone services. They paid $7.4 million in tax in FY 2015. That money is distributed to more than 900 local government units where the companies have property.

Public Utility Property Tax

Public utilities subject to this tax on tangible personal property include electric, rural electric, natural gas, pipeline, water works, water transportation, heating, and telegraph companies. Rates vary by taxing jurisdiction. Collections in Calendar Year 2015 totaled $1.0 billion. This tax is distributed to counties, municipalities, townships, school districts and special districts according to the taxable values and total millage levied by each.

Resort Area Tax

This is a tax of up to 1.5 percent levied on goods and services that would be subject to the sales tax but are involved as taxable transactions within a designated resort area (i.e. Kelley's Island, village and township of Put-in-Bay). Collections totaled $1.3 million in fiscal year 2015 and were distributed to the township or municipality that levied the tax.

Sales & Use Tax

As mentioned earlier, both county governments and transit authorities have an ability to levy this tax. Receipts in FY 15 totaled $2.4 billion. Of that amount, the county share was $1.9 billion.

School District Income Tax

This tax has been adopted by about 190 of Ohio's 614 school districts. It is paid by residents of those school districts and can be applied against either a "traditional" base or an "earned income" base. The traditional base is the same as that subject to the individual income tax. The earned income base is just that – earned income. It does not tax retirement income, capital gains, dividends, interest or other 'unearned' income sources. It also excludes military pay received by a taxpayer stationed outside of Ohio. This tax generated $403.2 million in FY 2015 with payments being distributed to the school districts levying the tax.

Before I conclude my remarks I would like to briefly mention two significant taxes paid by Ohioans that the Department of Taxation does not directly administer. The real property tax is supervised by the department but otherwise directly administered, collected, and distributed by Ohio county governments to help fund the functions and services provided by various units of local government, primarily public school districts. Finally there is the municipal income tax which is the primary source of revenue for most Ohio cities and many villages. State laws provide a governing structure for this tax but otherwise state government has no direct involvement with the administration of this tax.

With that, I'd be glad to answer any questions you have.

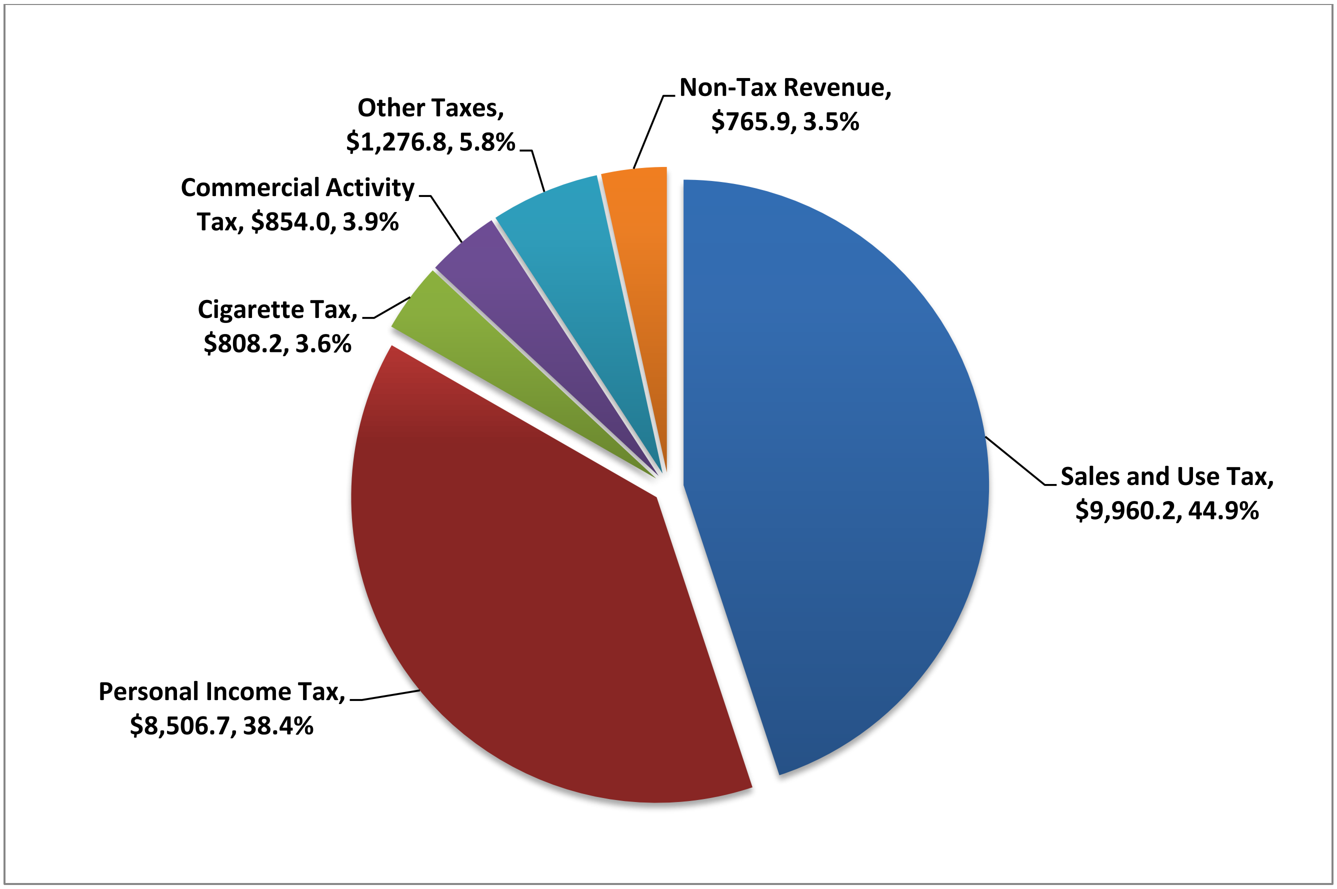
Q & A

Thank you.

Appendix A:
General Revenue Fund Sources, Fiscal Year 2015
(excluding federal aid)
(dollars in millions)

Major Taxes:	Collections (net)	Percent of Total
Sales and Use Tax	$9,960.2	44.9%
Personal Income Tax	$8,506.7	38.4%
Cigarette Tax	$808.2	3.6%
Commercial Activity Tax	$854.0	3.9%
Total Major Taxes	**$20,129.0**	**90.8%**
Other Taxes:		
Kilowatt-Hour Excise Tax	$292.3	
Foreign Insurance Tax	$266.6	
Domestic Insurance Tax	$251.6	
Financial Institutions Tax	$182.1	
Alcoholic Beverage Taxes (including liquor gallonage)	$99.9	
Public Utility Excise Tax	$97.5	
Natural Gas Distribution Tax	$74.7	
Petroleum Activity Tax	$5.5	
Estate Tax	$3.1	
Corporation Franchise Tax	$2.5	
Other Business and Property	$0.8	
Total Other Taxes	**$1,276.8**	**5.8%**
Total Tax Revenue	**$21,405.8**	**96.5%**
Non-Tax Revenue:		
Earnings on Investment	$23.1	
Miscellaneous[1]	$742.8	
Total Non-Tax Revenue	**$765.9**	**3.5%**
	$22,171.8	**100.0%**

Source: Ohio Office of Budget and Management.
[1] Includes certain transfers into the general revenue fund, licenses and fees, and other income.


Non-Tax Revenue, $765.9, 3.5%
Other Taxes, $1,276.8, 5.8%
Commercial Activity Tax, $854.0, 3.9%
Cigarette Tax, $808.2, 3.6%
Sales and Use Tax, $9,960.2, 44.9%
Personal Income Tax, $8,506.7, 38.4%

TESTIMONY OF RICHARD VEDDER BEFORE THE
OHIO 2020 TAX POLICY STUDY COMMISSION,
MCKINLEY COMMITTEE ROOM 121, OHIO STATEHOUSE
COLUMBUS OHIO, THURSDAY, NOVEMBER 19

Senator Peterson, Representative McClain, and other Commission members:

I am Richard Vedder, Distinguished Professor of Economics Emeritus at Ohio University. I first worked on a tax study commission more than 50 years ago in Illinois, and although the location and economic environment has changed, the major principles governing sound public fiscal practice remain remarkably unchanged. Rather than delve primarily into lots of specifics, I will outline what I believe should be the major factors you should be looking at as you review Ohio's tax structure. There is a temptation to immediately promote pet ideas or attack unappealing taxes, but I think initially, you should resist that. You should do what your commission's name suggests: "study" –go back to school a bit. Ignore lobbyists, special interests, and political opportunists, and be good public stewards genuinely seeking a tax and revenue system that best fits the needs of the citizens of the Buckeye State. My testimony today emphasizes primarily basic principles, touching less on specific shortcomings or strengths of what we do.

This is a good time to be examining our tax system. We are not in the midst of a fiscal crisis requiring hasty emergency action. The state's economy is in decent shape, although we are in long-term national economic slowdown of historic proportions that no doubt will adversely impact on our fiscal future. The enormous rise of unfunded federal liabilities reflecting not only a huge national debt but also unsustainably large entitlement programs will also adversely impact us.

My testimony will do three things. First, I will talk about the properties of good taxation, since taxes constitute most state revenues, and are an important part of the revenue stream of local governments. Second, I will briefly discuss non-tax forms of revenues, such as fees and intergovernmental grants. Finally, I will look at issues of overall fiscal management, including budget forecasting and the problems of revenue volatility. Because time is valuable, I will remember what Elizabeth Taylor may have told her sixth husband: "I'll be brief," but given the complexity of the topic, forgive me for talking 30 minutes.

Properties of "Good" Taxes

Public finance experts have differing value systems, emphasizing different things when discussing optimal principles of taxation, but virtually all would agree that four things are desirable in any tax. First, a good tax is relatively simple, easy to understand, and does not require lots of resources to collect. Second, a good tax does not distort economic activity from what market forces reflecting the desires of consumers and the costs imposed on producers dictate. That implies a good tax does not reduce the rate of economic growth. Third, a good tax is perceived as fair, generally acceptable to the citizenry on equity grounds. Lastly, a good tax is transparent –its burden is generally observable and measurable.

I would note that debates over tax policy usually evolve because of differences in opinion over the relative importance of each of these four points, and even differences sometimes over whether a tax promotes or detracts from achieving one of the basic tenets of a good tax. Moreover, there are some tradeoffs involved, the most obvious of which is that a tax viewed widely as being fair or equitable might also have distortive effects on the use of resources and therefore reduce the rate of economic growth.

Administrative Costs and Tax Compliance

Consider two taxes each raising $100 million. One costs $20 million to collect, the other $1 million. Obviously, the tax with lower administrative costs is preferable. Also, a tax that nearly every person actually pays is preferable to one where 25 percent of taxpayers evade payment. *Good taxes are cheap to collect and hard to evade.*

Government bureaucrats tend to ignore the costs of compliance to the general public. The Tax Commissioner might say that income tax enforcement costs X number of dollars, but that excludes the value of the many hours of time that individual taxpayers spend computing their tax, or the costs paid professional tax preparation services. At the federal level, the complexity of the income tax imposes several hundred billion dollars of annual compliance costs on taxpayers. If 10 professional tax experts were asked to compute the federal income tax in a moderately complex situation, it would not be surprising if they come up with several different calculations of the tax owed. Simplicity in the tax code is usually a great virtue.

Tax Neutrality and Economic Growth Effects

If some forms of activity are taxed higher than others, resources are allocated away from what human desires and costs suggest are desirable. Beyond that, the Law of Supply is at work. If you reduce the compensation for producing goods and services, you reduce resource usage, production, and income. High marginal tax rates are particularly distortive, and the empirical evidence confirms they have significant adverse effects on economic growth. Indeed, economic decisions are generally made at the margin. This means usually a tax with a very wide base but low rates on additional activity is better from an economic growth perspective to taxes imposed on a small base but where the marginal tax rates tend to be very high. On this criterion alone, a flat rate tax is preferable to a tax with progressive rates.

Large credits and deductions eroding the tax base are also viewed as harmful. Also, deductions and credits tend to favor some forms of activity over others, violating principles of neutrality. Such deductions and credit add to tax complexity, and thus are usually suspect on grounds of administrative costs and ease of compliance.

Equity or Fairness

Around 1990, Margaret Thatcher's government in Britain proposed what essentially was a head tax –a fixed payment for every citizen. Such taxes are marvelously simple, neutral and transparent, not having any impact at the margin on economic behavior. But the furor of protest was so great that it ended Mrs. Thatcher's long tenure as prime minister. Why? Because the tax was viewed as hideously unfair –the burden was modest for affluent persons, but substantial for the poor, who paid the same amount in pounds as the rich. The tax was highly regressive –taking a much larger proportion of the income of the poor than the rich.

The quest for a fair or equitable tax is not an uncontroversial one, however. What is regarded as fair by some often is viewed as unfair by others. Some view a flat rate income tax as fair –everyone pays the same proportion of income to the government. Others believe in the "ability to pay" concept of equity that suggests the affluent should pay a higher proportion in taxes than others.

Equity also has other dimensions. Horizontal equity refers to fairness between persons of similar economic circumstance. If two persons both earn $75,000 a year but one pays $3,000 in state income taxes but the second pays only $1,000, some would say that is unfair –violating horizontal equity. Deductions and credits often contribute to perceived horizontal inequities.

Transparency

In a modern democracy, citizens should be aware of the tax burdens the government is imposing upon them. It is anti-democratic for lawmakers to impose burdens on taxpayers that are disguised or distorted in magnitude, and it contributes to decision-making often inconsistent with the will of the people.

Note this principle often runs counter to the instincts of politicians. Politicians love to impose a burden that is real but where voters fail to understand its magnitude. There is relatively little political cost to them. The violation of the transparency principle has occurred sometimes in Ohio.

Are Ohio's Major Taxes "Good" with Respect to Basic Principles?

Let's us evaluate the quantitatively most important taxes used in the Buckeye State with respect to the four major criteria just outlined.

Sales Taxes

Sales taxes are important at both the state and local level. They get high marks on administrative cost and transparency grounds, and pretty good on economic neutrality grounds as well. I do not observe empirically strong negative relationships between sales tax revenues and economic growth. Also sales taxes are typically slightly less volatile than income taxes, so revenue fluctuations arising from the business cycle are not as great as with income taxes. The exclusion of a large number of services and some goods from the base poses issues on both administrative and economic neutrality grounds. Changing modes of retail trade, particularly the Internet, have posed challenges.

The big complaint about sales taxes is on equity grounds. A general sales tax tends to be regressive. Affluent people spend a smaller percentage of their income on consumer goods purchased within Ohio than poorer persons. The exclusion of most food purchases from the sales base relieves that problem somewhat. Nonetheless, persons putting emphasis on vertical equity concerns and who believe in the ability to pay principle tend to prefer income to sales taxes. As people spend a greater proportion of their income outside the traditional retail sales environment, either on the Internet or other jurisdictions, the problem of sales tax base erosion grows. For example, cruise travel by Ohioans has boomed, but is mostly not subject to Ohio sales taxes.

Personal Income Taxes

The biggest fiscal changes in Ohio since 1970 relate to the enormous growth in personal income taxes. In 1970, Ohio did not have a state income tax. Today, Ohio not only has one, but it has been far more aggressive than most states in the use of income taxation by local governments. For example, to my knowledge Ohio is the only state with relatively extensive income taxation for school districts as well as for municipal governments.

Progressive income taxes tend to be relatively income-elastic, meaning they rise even faster than income itself. Inflation and economic growth has the unintended long term effect of increasing income tax burdens as people get pushed into higher income brackets.

Income taxes usually get relatively high marks on transparency grounds – people know what they are paying. Many persons praise income taxes also on equity grounds, and most of the arguments for increased income taxation are based on income distribution arguments. The income tax is progressive, while sales taxes are regressive.

There are, however, severe objections to income taxes on both economic neutrality/growth grounds and also at least somewhat on the grounds of administrative costs and complexity. There is overwhelming evidence that there is a statistically significant negative relationship between income taxation and economic growth. Literally millions of persons have left the 41 states with individual income taxes and moved to the nine states without them –states like Florida, Tennessee, Texas, Nevada, and Washington. States with high income taxes find resources moving to more congenial environments to work and invest funds. It is not an accident that Bill Gates lives in the state of Washington without an income tax. California, with a top marginal income tax rate exceeding 13 percent, is faring by almost any measure less well than fellow Sun Belt States Florida or Texas because the latter states have no income tax.

Income taxes work best from an economic growth perspective when tax rates are relatively flat and low, as opposed to highly progressive with high marginal rates. Interestingly, the three largest neighbors of Ohio, Michigan, Pennsylvania, and Indiana, all have flat rate income taxes.

Property Taxes

Property taxes are reasonably transparent, although renters of property invisibly pay them as the owners shift the tax forward. Business property taxes are arguably levies on production, just as income taxes are on work effort or dividends. Such taxes potentially reduce output. One huge issue arises because of property tax abatement schemes favoring some businesses over others, distorting economic activity and viewed negatively by tax professionals. There are very significant administrative cost issues that even have equity implications, specifically because of the constant need to reevaluate property values.

The biggest issue regarding property taxes relates to the geographic distribution of taxable property, and the fact that these taxes are used to significantly fund public schools. Some areas have highly capital intensive property from, say, power plants, while others are almost entirely reliant on residential housing. The unequal distribution in property tax revenues between school districts can be dealt with in several ways including reducing reliance on property taxes for funding school districts or converting them mainly into state collected and administered taxes. It can be argued, however, that the tie of property taxes to school funding along with the requirement that voters approve tax increases works to hold school districts accountable to the people for their actions.

Commercial Activities Tax

The Commercial Activities Tax enacted in 2005 raised $854 million in 2015. It has several deficiencies, which is why only five states have gross receipts taxes. Neighboring Michigan abandoned its equivalent of a CAT tax a few years ago. The tax is not transparent. Who pays it? Who knows? That is why politicians love it, of course. It is potentially very distortive of economic activity, and implicitly imposes very different rates on the value added to economic activity by different type of businesses, favoring capital intensive businesses. It also potentially provides incentives for vertical integration and large scale operation, a problem only partly alleviated by the $150,000 exemption. Fortunately, however, in Ohio the rate of the tax is relatively low. Attempts to raise the CAT tax, however, will no doubt occur, potentially increasing problems associated with this tax.

Taxes on Cigarettes and Alcoholic Beverages

In fiscal year 2015, Ohio collected over $800 million in tobacco excise taxes, and another $100 million in the general fund for alcoholic beverages. Economists generally are suspicious of excise taxes, on several grounds. Cigarette taxes, for example, are extremely regressive. When levied at very high rates, there are significant compliance costs associated with interstate smuggling. Our whole governmental regulatory apparatus with respect to alcoholic beverages makes no sense, raises too little revenue, and is extremely anti-competitive. It exists because the General Assembly is extremely susceptible to campaign contributions from the industry lobby, contributions arguably the equivalent of bribes.

Other Taxes

Time permits only a cursory mention of other taxes, including on utilities and insurance. In some respect, the violation of neutrality rules applies here –why tax insurance differently than transactions by other financial institutions? The area of probably greatest contention, however, relates to taxes on natural resource extraction –severance taxes on gas and oil, for example. Ohio's economic advantage in this area has increased considerably with technological advances in extraction, and it appears that Ohio's taxation is dramatically lower than other states. My guess is that the adverse effects of raising those taxes have been considerably overblown, and that the replacement of, say, some income tax revenues with enhanced severance taxes would on balance be growth inducing. If press accounts are even remotely correct, however, this would seem to be another area where the lobbyists, not you, are determining public policy, hindering this Commission's ability to improve the tax system.

Non-Tax Revenue Sources

Ohio receives enormous amounts from the federal government. I worry a lot that federal fiscal pressures may put that revenue in jeopardy, especially with regards to health care. An overdue revisiting of the federal-state fiscal arrangements is unfortunately beyond your jurisdiction.

Some revenues are raised using the benefit principle of public finance that suggests users of governmental goods and services should pay for them. The most important examples perhaps are tuition fees at state universities and motor fuel levies. The 28 cent a gallon gasoline tax is above the national average, but is clearly inadequate to fully fund highway infrastructure projects. At a time of relatively low gas prices, the political opportunity to raise that tax somewhat seems relatively large. It may well be the way we handle highways should change, including the privatization of some functions. Technology has evolved allowing the use of road tolls to a greater extent than previously, reducing reliance on gasoline taxes. The evolution of non-gasoline powered vehicles is another challenge.

Regarding tuition fees, with state funding declining as a share of budgets, so-called state schools are increasingly semi-private institutions, calling into question the role the state should play in establishing fees. There is overwhelming evidence that universities are costly and inefficient, that large portions of graduates are getting low paid jobs, and that students are not learning much while in school. The state may wish to rethink its future commitment with state institutions –maybe funding students, not schools. Legislative attempts to limit tuition fee growth are often ineffective, as schools can counter efforts by a variety of means.

We probably need to review fees for hunting, fishing, occupational licensing, recreational usage and so forth. We probably should end, say, licensing barbers and beauticians. We should ask ourselves whether charging to use state parks is a good or bad idea, or whether and how much should school districts be allowed to charge fees to participate in interscholastic athletics.

Financial Management, Forecasting, and Budgeting Rules

There is a big problem with revenue volatility. Expenditures tend to be relatively stable, but revenues fluctuate a lot. We must balance our budgets every two years. We help alleviate the problem by use of a budget stabilization fund. There is a dilemma in deciding how large that fund should be. Fiscal prudence argues for a large fund –say 10 or even 15 percent of annual revenues. Yet, with all due respect, some politicians are like alcoholics in liquor stores – they just cannot resist consuming the merchandise or, in this case, raiding the rainy day fund. If the fund is too big, it might get dissipated by politicians wanting to avoid doing other unpopular things. Still, as a general proposition, a good sized rainy day fund is desirable.

I think on the whole Ohio's budgeting and forecast system works well. Mr. Keen and most of his predecessors are extremely conservative in their forecasts, and that is good because forecasting errors in the direction of having extra revenues is preferable to shortfalls requiring hasty last minute budgeting cutting that can be disruptive of programs.

Ohio's State Revenue System: An Overall Assessment

Let me conclude by offering my overall assessment of Ohio's revenue system. I think Ohio's biggest problem over the last half century has been a slow rate of economic growth. Ohio has underperformed the nation, and even the nation as a whole is lagging historical norms. The equity problems relating to taxes are not big in this state. The distribution of income in Ohio is more equal than the nation as a whole, and the alleged regressivity of the tax system is less pronounced in Ohio than nationally. For example, we still have a good deal of progressivity in our income tax. Big inequities need to be dealt with on the federal level. Thus I am more worried about the economic growth effects of our tax policies than the equity effects.

As a consequence, I have applauded the efforts of the past decade, most recently by the Kasich Administration, to reduce Ohio's excessively high marginal income tax rates. It is still true that Ohio taxes its most productive citizenry at the margin more than in Indiana, Michigan or Pennsylvania, our leading neighbors. The Tax Foundation ranks Ohio a lowly 42th on its just released business Tax Climate Index for 2016. Ohio's improved economic performance in the last few years reflects reductions in income taxation but clearly much more needs to be done.

Government is less efficient than the private sector, so smaller government would be good –we need to control expenditures better. Also, a flat rate income tax with a rate similar to that in Indiana- ranked 8th by the Tax Foundation-- would seem to be a worthwhile goal.

Thank you.

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Ohio 2020 Tax Policy Study Commission
Testimony of Albert F. Macre CPA
November 19, 2015

Co-Chairs Peterson and McLain and members of the Ohio 2020 Tax Policy Study Commission, my name is Albert F. Macre. I am a Certified Public Accountant, Professor of Accounting at Franciscan University, and member of the National Federation of Independent Business Ohio Leadership Council at whose request I am here today representing our 25,000 members.

Since my accounting practice is located in Steubenville, I have a broad perspective on the tax differences that exist between Ohio and its eastern border states. For those of you who are unfamiliar with the geography, Steubenville is located directly across the Ohio River from the City of Weirton, West Virginia, which is bounded on its eastern border by the State of Pennsylvania. As such, over the last twenty-five years, I have lived through many changes in tax policy, not just in Ohio, but in West Virginia and Pennsylvania as well. And while I can't give you precise statistics, the choice of which state in which to locate or relocate a business has come up on a regular basis during my career. And like all good advisors, for many years, my first answer has been "it depends."

But over the last few years, my answer has changed. Thanks to the efforts of the Ohio Legislature and Governor during the last five years, and in addition to some measures taken prior to that, Ohio has moved ahead by leaps and bounds in terms of its standing as a "business-friendly" environment. Taken alone, the elimination of the Ohio Estate tax, once one of the most oppressive in the country, the creation of the Small Business Investors Deduction, and the yet-to-be-felt effects of Ohio municipal tax reform, each

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would have been a major improvement in our State's tax policy. Collectively, they have propelled Ohio ahead of its border competitor states. And although the majority of Ohio's businesses are no longer organized as stand-alone taxable corporations, the elimination of the corporate franchise tax over ten years ago is undoubtedly an advantage to those entities. Lastly, the elimination of Ohio's business personal property tax has been a significant factor in influencing where businesses with inventories and capital assets locate.

But if the job were complete, there would be no 2020 Tax Policy Study Commission. Each of you would likely be listening to someone else talk about anything more interesting that tax policy and I would be back in my office thinking about what to eat for lunch.

To begin my discussion, I think it would be useful to the Commission to look at the tax rate structures in our border states and how Ohio taxes fit into the mix.

In terms of corporate taxes, both West Virginia and Pennsylvania still levy an income and corporate franchise tax on C-Corporation taxable income and net asset book value. Unlike Ohio, which never taxed the capital of an S-Corporation or Partnership, both Pennsylvania and West Virginia do so. Both also levy a franchise tax on partnerships as well. The current corporate tax rates in Pennsylvania and West Virginia are 9.99% and 7.75%, respectively. To the west, Indiana and Kentucky also levy taxes on corporate income, with Indiana assessing a flat rate of 6.5% and Kentucky applying a three-tiered rate structure of 4-5-6%.

From an individual rate standpoint, Pennsylvania has a flat rate of 3.07%, just below the rate that this Commission envisions for Ohio. West Virginia has a graduated rate structure with a top rate of 6.5% which you hit at $65,000 in taxable income. Indiana has a flat tax of 3.3% and Kentucky has a graduated rate schedule from 2% to 6%, with the highest rate becoming effective at taxable income of $75,000. Ohio's highest marginal rate is 5.33%, but not until taxable income hits $208,500. Married Ohioans are able to further reduce their effective tax rate by filing separate returns.

I have attached a spreadsheet showing the tax liabilities for filers in each of these states at taxable income levels of $25,000, $50,000 and $100,000.

Part of the reason Pennsylvania is able to operate at such a low rate is that individuals are not able to deduct business losses, rental losses or capital losses. Also, Pennsylvania does not allow salary deferral reductions for profit sharing plans, opting to tax the pre-deferral wage amounts. This prevents an employee who earns his living in Pennsylvania from paying taxes on a portion of those wages (in the form of retirement benefits) to another state to which he might relocate after retirement, and in some cases paying no tax if that individual relocates to a state with no income tax. Lastly, Pennsylvania real estate taxes are significantly higher than Ohio's.

My understanding is that one of the charges to this commission is to review all current state tax credits. I would like to address four of these.

<u>The Ohio Joint Filing Credit</u> – Ohio is the only state, to my knowledge, which offers a credit of this type, where dual-income couples are eligible for a reduction of their total tax liability by up to $650. To receive the maximum credit, a couple would need to have taxable income of over $250,000. At that level of income, the loss of this credit would be offset by the lower flat rate contemplated by the commission. Those at the lower end of the income

spectrum that qualify for the maximum credit percentage are saving just over $90.

The Political Contribution Credit – Ohio is one of a handful of states that have a credit of this nature. Oregon just eliminated a similar credit for high income taxpayers and Minnesota suspended its credit on July 1, 2015. My belief is that these credits don't motivate taxpayers to become political contributors any more than itemized deductions motivate individuals to contribute to their parish or the United Way. Furthermore, I don't feel that any state should require its taxpayers to subsidize political contributions. To me, it seems unconscionable that any Republican taxpayer should subsidize the political contributions of a Democrat or vice-versa.

The Lump Sum Retirement Credit and Lump Sum Distribution Credit – In the twenty-five years I have been in practice, I can't recall a single instance of a taxpayer using this credit. In fact the credit is so rare, that the instructions and worksheets used to calculate the credit aren't even included in the Ohio Tax Return Instructions Book. Also, this credit requires the taxpayer to forgo future Senior Citizen or Retirement Credits, in some cases for the rest of their lives. Lastly, these credits discriminate against taxpayers who work for any non-profit entity which maintains a 403 (b) plan instead of the 401(k) arrangement used by "for profit" entities.

I would suggest that the Commission strongly re-think the value of these credits if the movement to an Ohio flat tax is a possibility.

The last issue I would like to discuss is the Ohio Commercial Activity Tax, of which I have never been a big fan. I believe the tax is inherently unfair for a variety of reasons. First, it requires business entities with losses to pay taxes to the state. Secondly, I believe the state would be better served by

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welcoming businesses into a vibrant economic environment where the opportunity for profits is great, as opposed to assessing a tax on gross receipts simply for the privilege of engaging in commercial activity in Ohio. Lastly, and most significantly, when analyzed as an income tax, the CAT Tax punishes businesses with lower profit margins.

An example prepared by the Tax Foundation in its December 2006 Special Report on the Economic Consequences of Gross Receipts Taxes used the following example to illustrate my last point:

	Low Margin Grocerery	High Margin Software Dev.
Sales	$1,000,000	$1,000,000
Cost of Business Inputs	950,000	500,000
Profit	50,000	500,000
Profit Margin %	5%	50%
Gross Receipts tax at 1%	$ 10,000	$ 10,000
Gross Receipts Tax as a % of Profit	**20%**	**2%**

The complete study, which I include with my testimony, resulted in four findings:

1. There is a growing trend among states toward replacing corporate income taxes with Depression-era gross receipts taxes.

2. Gross receipts taxes are poor tax policy. They lead to harmful "tax pyramiding," distort companies' structures, and damage the performance of state and local economies.

3. The administrative simplicity and low rates of gross receipts taxes are illusory. Lawmakers are forced to add complexity to correct for their structural flaws, and some industries face high effective tax burdens despite low statutory rates.

4. States in search of alternatives to corporate taxes should not rely on economically harmful gross receipts taxes.

As the commission continues its work, I would encourage it to consider some of these findings as they relate to our current Commercial Activity Tax.

In closing, I would like to thank the commission for allowing me the opportunity to share my thoughts. I would hope that the information I have presented has some value as you move forward toward your goal of making Ohio a more "business- friendly" state. I wish you the best in that regard.

If there are any questions, I would be happy to try to answer them.

Submitted by Albert F. Macre, CPA - November 19, 2015

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Ohio and Border States Individual and Corporate Tax Rate Comparison

	Ohio	Indiana	Kentucky	Pennsylvania	West Va.
Personal Tax Rate Range					
Low	0.53%	-	2.00%	-	3.00%
High	5.33%	-	6.00%	-	6.50%
Flat Tax	-	3.30%	-	3.08%	-
Taxable Income at High Bracket	$208,500	-	$75,000	-	$65,000
Tax on $25,000 before any credits	$762	$825	$1,266	$770	$900
Tax on $50,000 before any credits	$1,701	$1,650	$2,716	$1,540	$2,175
Tax on $100,000 before any credits	$3,235	$3,300	$5,666	$3,080	$5,375
Hypothetical Ohio Taxes at 3.5%					
Tax on $25,000 before any credits	$875	-	-	-	-
Tax on $50,000 before any credits	$1,750	-	-	-	-
Tax on $100,000 before any credits	$3,500	-	-	-	-
Corporate Tax Rate	n/a	6.50%	6.00%	9.99%	7.75%
Tax on $100,000 Corp. Net Income	n/a	$6,500	$6,000	$9,990	$7,750

Notes:

1. Indiana corporate rate phasing down to 4.9% by 2022.
2. Kentucky corporate tax rate is graduated; 4% on first $50,000; 5% on the next $50,000; then 6% on over $100.000.

TAX FOUNDATION

SPECIAL REPORT

December 2006
No. 147

Tax Pyramiding: The Economic Consequences Of Gross Receipts Taxes

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I. Introduction

State governments have traditionally raised revenue from business by taxing corporate income.[1] But in recent years the growing difficulty of administering state corporate income taxes has prompted a search for alternative ways of taxing companies. This search for new business taxes has ironically sparked a resurgence in one of the world's oldest broad-based tax structures: the gross receipts tax, also known as the "turnover tax."

Key Findings:

- *There is a growing trend among states toward replacing corporate income taxes with Depression-era gross receipts taxes.*
- *Gross receipts taxes are poor tax policy. They lead to harmful "tax pyramiding," distort companies' structures, and damage the performance of state and local economies.*
- *The administrative simplicity and low rates of gross receipts taxes are illusory. Lawmakers are forced to add complexity to correct for their structural flaws, and some industries face high effective tax burdens despite low statutory rates.*
- *States in search of alternatives to corporate income taxes should not rely on economically harmful gross receipts taxes.*

Gross receipts taxes have a simple structure, taxing all business sales with few or no deductions. Because they tax transactions, they are often compared to retail sales taxes. However, they differ in a critical way. While well designed sales taxes apply only to final sales to consumers, gross receipts taxes tax *all* transactions, including intermediate business-to-business purchases of supplies, raw materials and equipment. As a result, gross receipts taxes create an extra layer of taxation at each stage of production that sales and other taxes do not—something economists call "tax pyramiding."

Advocates of gross receipts taxes generally defend them on two grounds. First, it is argued that their simple structure makes them easy for states to administer and for companies to comply with, in contrast to notoriously complex state corporate income taxes. Second, because they tax an expansive base of all transactions in the economy, they are able to raise a given amount of revenue at lower rates than any other tax, making them politically attractive to lawmakers.

But while gross receipts taxes appear to be a simple alternative to complex corporate income taxes, this simplicity comes at a great cost. Gross receipts taxes suffer from severe flaws that are well documented in the economic literature, and rank among the most economically harmful tax structures available to lawmakers. The economic problems with gross receipts taxes are not the result of poor implementation by lawmakers. The flaws are

Acknowledgment: The authors wish to thank Joseph D. Henchman for research assistance.

[1] Property, excise, and other indirect taxes commonly affect businesses in addition to corporate income and gross receipts taxes.

inherent in their design. State lawmakers searching for alternatives to complex state corporate income taxes should be wary of gross receipts taxes, and should instead seek more economically neutral ways of taxing business.

II. Brief History of Gross Receipts Taxes

Although European countries experimented with turnover taxes as early as the 14th Century,[2] gross receipts taxes did not appear in the United States until West Virginia lawmakers enacted a "business and occupations privilege" tax on gross business sales in 1921. While the tax was the nation's first statewide gross receipts tax, the tax was an unimportant revenue source during its early years. After its enactment, West Virginia, like most U.S. states at the time, continued to rely mainly on property tax revenues throughout the 1920s.

With the onset of the Great Depression in 1929, state finances underwent dramatic change. As state and local economies sank into deep recession, property and income tax collections plummeted sharply, precipitating fiscal crises in many states. Frantic for stable sources of tax revenue, lawmakers soon turned to sales and gross receipts taxes as emergency revenue sources.

Depression-Era Rise of Gross Receipts Taxes

At the economic low-point of the Depression in 1933, Washington enacted the nation's second statewide gross receipts tax. The Washington State Department of Revenue describes the tax as a "temporary, emergency revenue

Table 1
Overview of States with Significant Gross Receipts-Type Taxes

State	Items Taxed	Deductions and Exemptions
Delaware	Gross receipts tax on all non-exempt goods or services rendered. Rates range from 0.096 percent to 1.92 percent depending on business activity, in addition to place-of-business fees ranging from \$25 to \$75 per location: • Manufacturers: 0.180 percent. • Wholesalers: 0.307 percent. • Retailers: 0.576 percent. • Restaurants: 0.499 percent. • Food Processors: 0.154 percent. • Petroleum Products Wholesalers: 0.384 percent, plus a hazardous substances tax of 0.9 percent, plus a surtax of 0.192 percent. • Occupational/Professional/General Services: 0.384 percent. • Steam, Gas, Electric Utilities: 0.1 percent. • Additional rates for more specific industries.	Exemptions include tobacco, fuel taxes, and transactions between entities owned by the same 5 or fewer individuals or one family.
Kentucky	Alternative minimum calculation for business taxes of 0.095 percent gross receipts or 0.750 percent of gross profits. Kentucky school districts may levy a 3 percent gross receipts tax on utilities.	Exemptions include dividend income, 50 percent of income from coal disposal, and income from safe harbor leases. Investment companies are exempt from the alternative minimum calculation, as are sole proprietorships, partnerships, and some LLCs.
Michigan	Scheduled to expire December 31, 2007: Single Business Tax (SBT), which incorporates features of gross receipts taxes and value-added taxes. Imposed on most business entities, with gross receipts used in calculating the tax base. Current rate is 1.9 percent.	Exemptions include the first \$45,000 of tax base, up to \$48,000 for partnerships and small corporations, with reductions as income rises. Governmental agencies, nonprofits, agricultural producers and others are exempt.

Source: CCH, Inc.; Tax Foundation

[2] John F. Due, *Indirect Taxation in Developing Countries,* Chapter 6 (John Hopkins Press, 1970).

[3] Washington State Department of Revenue, *Tax Reference Manual 2005,* p. 101. Washington State's temporary tax was replaced and made permanent in 1935 with the launch of the Business & Occupations Tax.

measure during the Depression."[3] Indiana soon followed suit with a similar "gross income tax" in 1933. Faced with similar fiscal emergencies, a cascade of state and local governments followed suit, often enacting gross receipts taxes on specific industries rather than broad tax bases. By 1934, *Tax Magazine* would report that,

> The drive for new revenue resulted in the adoption of gross income or gross sales taxes in fifteen states... The development of the gross income or gross sales taxes is probably the outstanding tax news of the year.[4]

As the fiscal pressures of the Depression waned, interest in gross receipts taxes faded. Most gross receipts taxes enacted in the 1930s ultimately proved to be short-lived. By the onset of World War II, many had been repealed or struck down by courts as unconstitutional. By the 1950s and 1960s, gross receipts taxes began to fade from state tax policy debates. During the full second half of the 20th Century, no state would enact a new broad-based gross receipts tax.[5]

By the late 1970s state and local lawmakers began yielding to the advice of economists, repealing gross receipts taxes in favor of less harmful revenue sources. New Jersey abandoned its state-level gross receipts tax in 1977. Alaska soon followed suit, repealing its tax in 1979.[6] Citing concerns about the health of state and local economies, West Virginia and

Table 1 (continued)
Overview of States with Significant Gross Receipts-Type Taxes

State	Items Taxed	Deductions and Exemptions
New Jersey	Expired in July 2006: Alternative minimum assessment for business taxes. Levied on companies with over $2 million in gross receipts. Rates range from 0.125 percent to 0.4 percent based on receipts.	Exemptions include corporations with less than $2 million in receipts; S corporations; investment companies; professional organizations; cooperatives.
New Mexico	General gross receipts tax. Widely considered to resemble a retail sales tax. Rate is 5 percent. Counties may add an additional 2.1875 percent. Railroad car companies are taxed at 1.5 percent.	Exemptions include prescription drugs, certain food and medical expenses, interest and dividends, salaries, wages, commissions, homeowner dues, and earnings from farms and Internet businesses.
Ohio	Commercial Activities Tax (CAT) enacted in 2005, to be phased-in over a five-year period. When fully phased-in, rate is 0.260 percent of gross receipts. Imposed on all activity, legal or illegal, that is conducted for or results in gain, profit, or income. Utilities are taxed separately at 4.75 percent, except oil pipelines, which are taxed at 6.75 percent.	Exemptions include nonprofit organizations, entities with less than $150,000 in receipts, and utilities paying utility taxes.
Texas	Effective January 1, 2007: General gross receipts tax. Rate is 1 percent, calculated on the minimum of either a) total revenue minus total cost of goods, or b) total revenue minus total compensation and benefits. Wholesalers and retailers are taxed at 0.5 percent.	Exemptions include sole proprietors and general partnerships, and businesses with less than $300,000 in gross receipts (see Footnote 9).
Washington	Business & Occupation (B&O) tax, the nation's oldest general gross receipts tax. Rates vary widely based on industry: • Manufacturing Dairy Products: 0.138 percent. • Travel Agent Commissions: 0.275 percent. • Retailing: 0.471 percent. • Wholesaling: 0.484 percent. • Manufacturing: 0.484 percent. • Gambling Contests of Chance: 1.5 percent. • Additional rates for more specific industries.	Exemptions include entities with gross income less than $28,000. Features dozens of specific deductions and exemptions, including investments, dues, interest on agricultural loans, health care providers, beef processing, research and development, insurance premiums, real estate sales, nonprofit organizations, janitorial services, and fruit and vegetable processing.

Source: CCH, Inc.; Tax Foundation

4 Raymond E. Manning, "State Tax Legislation, 1933." *The Tax Magazine* (February 1934), p. 63.

5 Joseph R. Crosby, "The Trouble with the Commercial Activity Tax." *Ohio Matters* (Ohio Chamber of Commerce, May/June 2005).

6 John F. Due and John L. Mikesell, *Sales Taxation: State and Local Structure and Administration*, p. 55 (Urban Institute Press, 1994).

Indiana abandoned their decades-old gross receipts taxes in 1987 and 2002, respectively. By the close of 2002, Washington stood alone as the only state with a surviving Depression-era gross receipts tax.

Case Study: Harmful Effects of Washington State's Gross Receipts Tax

Washington State levies the nation's oldest broad-based gross receipts tax. First enacted in 1933 and significantly revised in 1935, the state's Business & Occupation (B&O) Tax illustrates many of the flaws inherent in taxing gross receipts.

In 2002, a tax reform commission appointed by the state's legislature concluded that the B&O tax results in substantial tax pyramiding and is highly non-neutral across products and industries, violating basic principles of good tax design. From the committee's report:

"Neutrality requires that a tax system minimize the opportunities and incentives for taxpayers to alter their decisions in order to take advantage of differential tax treatment of economic activity.

"The finding for the Washington State tax system is that it causes substantial nonneutralities for both businesses and households. The pyramiding of the B&O tax creates the main non-neutralities for businesses. Pyramiding of taxes is the payment of taxes by different companies on the same goods or services. This occurs when goods or services of one company are inputs for another's production and/or sales. Thus, a tax is paid multiple times on a product as it moves through the production chain.

"The B&O tax pyramids an average of 2.5 times, but this rate varies considerably across industries. The B&O tax on many services pyramids at about 1.5 times, whereas for some types of manufacturers the rate of pyramiding is over five or six times. This causes effective B&O tax rates (the rate paid on the value added to goods and services by an enterprise) to vary considerably from industry to industry."

The commission found the B&O tax causes tax pyramiding of up to 6.7 times on some manufacturing industries, while some services are taxed just 1.4 times. Effective tax rates vary from less than 1 percent on retail trade to more than 3 percent on electric and gas utilities, leading to potentially large economic distortions in the state's economy.

The following table *(see page 5)* illustrates the sharp degree of tax pyramiding under the B&O tax, and the wide variation in effective tax rates on industries.

(continued on page 5)

The "New Era" of Gross Receipts Taxes

Just as the nation's few remaining gross receipts taxes were being repealed by states, lawmakers in New Jersey gave birth to a surprising new trend in business taxation that some have called a "new era of gross receipts taxes."[7]

As part of a business tax reform in 2002, New Jersey launched an "alternative minimum assessment" (AMA), enacting the first statewide gross receipts tax in decades. The AMA required companies to pay the larger of either regular corporate income taxes, or a gross receipts tax. Although the tax was short-lived—it expired four years later in July 2006—its effects were dramatic, laying the groundwork for a resurgence of gross receipts taxes in recent years.

In January 2005, Kentucky followed New Jersey's lead and enacted an "alternative minimum assessment" gross receipts tax. In July 2005, Ohio lawmakers enacted the controversial Commercial Activity Tax (CAT), replacing corporate franchise and personal property taxes with a broad-based gross receipts tax that is phased-in over five years. Reminiscent of Depression-era arguments, Ohio lawmakers cited plummeting revenue from corporate franchise taxes as the main reason for establishing a gross receipts tax.[8]

In May 2006, Texas joined the growing list of states with gross receipts taxes. Governor Rick Perry signed into law a sweeping tax reform bill, replacing Texas's corporate franchise tax with a "margin tax" based on gross business receipts.[9] Citing the difficulty of administering corporate income taxes, Texas lawmakers defended the margin tax as a way to close "gaping loopholes" in the tax base and enact "a [statutory] tax rate that is substantially lower than the one we have today."[10]

After several decades of dormancy, gross receipts taxes are again rising in popularity. Just as states turned to gross receipts taxes during the Depression's fiscal crises, the perceived crisis of administration in state corporate in-

[7] Giles Sutton, Nicholas E. Ford, Jamie C. Yesnowitz and Chris Hopkins, "The Continuing Evolution of Gross Receipts Taxes." Conference Presentation. (Grant Thornton LLP's 9th Annual Printing Industry Tax Conference, February 12-14, 2006).

[8] Brian Sigritz, "Examining Ohio's Commercial Activity Tax." *State Tax Notes* (February 20, 2006).

[9] Because the Texas "margin tax" allows deductions for either compensation or the costs of goods sold, it is more properly classified as a hybrid gross receipts tax rather than a "pure" one.

[10] Texas Office of the Governor, "Gov. Perry Signs Landmark Business Tax Reform," News Release (May 18, 2006). Available at http://www.governor.state.tx.us/divisions/press/pressreleases/PressRelease.2006-05-18.1748.

come taxes has reignited debate over the simple but flawed structure of gross receipts taxes.

Other Gross Receipts Taxes

In addition to broad-based gross receipts taxes, many state and local governments over the years have enacted hybrid business taxes that, while not pure gross receipts taxes, resemble them in economically important ways.

Delaware, New Mexico and Hawaii each levy taxes commonly referred to as "gross receipts taxes," but which incorporate elements of both sales and gross receipts taxes. Michigan levies a "Single Business Tax" that incorporates some features of a gross receipts tax and some of a European-style value-added tax. Finally, many states tax the gross receipts of only certain industries, such as utilities, telecommunications and gambling.

Overall at least 30 states and the District of Columbia levy some form of broad-based or industry-specific gross receipts tax. Because of statutory complexity and wide diversity of provisions, it is difficult to classify many state taxes as "gross receipts taxes" with any degree of confidence. Table 1 provides an overview of states that can reasonably be said to levy taxes that resemble gross receipts taxes in important ways.

(continued from page 4)

Tax Pyramiding Caused By Washington State's Gross Receipts Tax

Industry	SIC Code	Effective Tax Rate on Value Added	Degree of Tax Pyramiding
Manufacturing - Food	20	2.0 %	6.7
Manufacturing - Petroleum Refining	29	3.1	6.7
Manufacturing - Aircraft & Parts	372	2.6	5.3
Manufacturing - Rubber & Plastics	30	2.0	4.3
Manufacturing - Primary Metal	33	2.0	4.1
Manufacturing - Apparel & Textiles	22-23	2.0 %	4.1
Manufacturing - Lumber & Wood Products	24	1.9	4.0
Manufacturing - Professional & Scientific Instruments	38	1.8	4.0
Manufacturing - Industrial & Commercial Machinery & Equipment	35	1.9	3.9
Manufacturing - Furniture & Fixtures	25	1.8	3.7
Manufacturing - Other Transportation Equipment	37	1.9 %	3.7
Manufacturing - Paper Products	26	1.7	3.7
Manufacturing - Stone, Clay & Glass	32	1.6	3.4
Manufacturing - Chemical Products	28	1.5	3.3
Construction	15-17	1.6	3.3
Manufacturing - Electronic Equipment (Except Computers)	36	1.4 %	2.8
Manufacturing - Leather & Leather Products	31	1.4	2.8
Movies, Amusement & Recreation	78-79	2.3	2.7
Miscellaneous Repair Services	76	1.4	2.7
Manufacturing - Miscellaneous Manufacturing Industries	39	1.2	2.7
Manufacturing - Printing and Publishing	27	1.4 %	2.6
Railroad, Air, Water & Other Transportation	40-47	1.8	2.5
Mining & Quarry	10-14	1.2	2.4
Manufacturing - Fabricated Metal	34	1.1	2.3
Lodging Services	70	1.1	2.2
Barbers, Dry Cleaning and Other Personal Services	72	2.0 %	2.1
Agriculture, Forestry & Fishing	1-9	1.4	2.0
Auto Repair Services	75	1.0	2.0
Communications	48	1.2	1.9
Wholesale Trade	50-51	0.9	1.9
Legal, Engineering & Accounting	81-89	2.1 %	1.8
Advertising, Mailings, and Other Business Services	73	1.6	1.7
Retail Trade	52-59	0.8	1.6
Medical & Health Services	80	2.0	1.6
Finance, Insurance & Real Estate	60-67	1.5	1.6
Electric, Gas & Other Utilities	49	3.2 %	1.5
Computer Programming and Data Processing	737	1.3	1.4
State Total		*1.5 %*	*2.5*

Source: Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State: A Report to the Legislature," Volumes 1 & 2 (November 2002).

III. The Mechanics of the Gross Receipts Tax

Before any tax can be levied its *base*, or what gets taxed, must be determined. Under corporate income taxes, the difference between a company's sales and its costs of production serves as the tax base. While sales are relatively simple to measure, assigning business costs to arrive at taxable income is fraught with complexities, making corporate income an inherently difficult tax base to administer.[11]

Further complicating corporate income taxes is that companies often do business in more than one jurisdiction. This requires difficult questions of where companies earned income, which states have taxing authority over it, and for how much. These questions have become increasingly unmanageable in recent years as the number of companies operating in multiple states has increased.[12]

The perception among lawmakers that there are growing administrative problems of state corporate income taxes has sparked an interest in moving toward simpler tax bases in recent years, including gross receipts taxes. Conceptually, implementation of a gross receipts tax is straightforward. Companies total up in-state revenue earned during a time period, apply the statutory tax rate, and pay the

[11] Arthur P. Hall, "The Compliance Costs and Regulatory Burden Imposed by the Federal Tax Laws." *Tax Foundation Special Brief* (January 1995).

[12] Chris Atkins, "A Twentieth Century Tax in the Twenty-First Century: Understanding State Corporate Tax Systems." *Tax Foundation Background Paper*, No. 49 (September 2005).

tax. This relatively simple process eliminates the need for complex determinations of corporate profit, an attractive feature to state revenue officials.

However, the administrative simplicity of gross receipts taxes comes at a high price. Taxes on gross sales have long been recognized as inherently non-neutral taxes, causing potentially large economic distortions throughout the economy. Although few states levy pure gross receipts taxes, the following analysis of their economic effects applies in varying degrees to all states levying gross receipts-type taxes.

IV. Tax Pyramiding, Vertical Integration and Effective Tax Rates

Economists agree that the marketplace, rather than peculiarities of the tax code, should determine both the relative prices of goods and the way companies choose to organize themselves. For this reason, there is general consensus that the tax system should be as *economically neutral* as possible. A well designed tax should aim to minimize how much it steers individuals' choices away from those they would have made in the absence of taxes.

Gross receipts taxes have long been recognized as being non-neutral, compared to other broad-based taxes.[13] Structural features of gross receipts taxes tend to distort the composition of goods produced in the economy, as well as the structure of firms that provide them, making them an economically harmful revenue source.

Gross Receipts Taxes Lead to Tax Pyramiding

Under a gross receipts tax every item that changes hands between companies is taxed, regardless of whether it is a final product or raw material. As a result, in industries where products move through multiple stages of production—from raw material to manufacturing, distribution, and so on—the value created in early stages of production is taxed repeatedly in subsequent stages. Economists call this phenomenon "tax pyramiding." This repeated taxing at each link in the production chain results in punitively high effective tax rates on complex products produced in stages by more than one company, and low rates on products with few production stages or that are produced entirely in-house.

Table 2 provides a stylized illustration of how tax pyramiding affects three hypothetical

Table 2
How Tax Pyramiding Penalizes Industries with Multiple Production Stages

Lumber Products Production Stage	Cost of Business Inputs	Value Added	Sale Price to Next Production Stage	Gross Receipts Tax (1 Percent, Fully Forward-Shifted)
Timber Cutting	$ 0	$ 1,000	$ 1,000	$ 10
Milling and Processing	$ 1,010	$ 1,000	$ 2,010	$ 20.10
Wholesale Distribution	$ 2,030.10	$ 1,000	$ 3,030.10	$ 30.30
Retail Sales	$ 3,060.40	$ 1,000	$ 4,060.40	$ 40.60
Total		$ 4,000		$ 101.01
Effective Tax Rate on Lumber and Wood ($101.01 ÷ $4,000): 2.53 percent				
Auto Repair				
Parts Manufacturing	$ 0	$ 1,000	$ 1,000	$ 10
Retail Sales of Parts & Labor	$ 1,010.00	$ 1,000	$ 2,010.00	$ 20.10
Total		$ 2,000		$ 30.10
Effective Tax Rate on Auto Repair ($30.10 ÷ $2,000): 1.51 percent				
Computer Programming				
Programming Labor Time	$ 0	$ 1,000	$ 1,000	$ 10
Total		$ 1,000		$ 10
Effective Tax Rate on Computer Programming ($10 ÷ $1,000): 1 percent				

Note: Illustration assumes a one percent gross receipts tax levied on business sales, full forward-shifting of the economic incidence of the tax, and $1,000 of value added at each stage of production. Producers at the first stage of production are assumed to have zero input costs to simplify calculations.
Source: Tax Foundation

[13] "Federal Non-Income Taxes: An Examination of Selected Revenue Sources," *Tax Foundation Research Publication,* No. 1 (April 1965), p. 44-46.

[14] This assumption is made for simplicity only. The conclusions of the illustration are unaffected if the tax incidence is instead assumed to be shifted backward, or divided in some fashion between buyers and sellers.

industries: lumber products, auto repair, and computer programming. The illustration assumes a one percent gross receipts tax on sellers, which is assumed to be fully passed forward onto buyers at subsequent stages of production.[14]

In the illustration lumber is produced in four stages: timber cutting, milling and processing, wholesale distribution, and retail sales. As wood products pass from one company to the next as they move through production stages, the full value of each business-to-business sale is taxed. By the end of the fourth stage, this repeated taxation results in an effective tax rate of 2.53 percent on the total value added for lumber products—more than two and one-half times the statutory rate. In contrast, auto repair services are produced in just two stages of production, resulting in an effective tax rate of 1.51 percent. Computer programming is the only industry that completely avoids tax pyramiding, as it is produced entirely in one stage.

Why Can't Gross Receipts Taxes Be Made Transparent?

A basic principle of good tax design is that taxes should be transparent to taxpayers. Just like consumers need information about prices to make good buying decisions in the marketplace, taxpayers need good information about the "price" of government programs in order to make good choices about the level of spending they demand from elected officials.

Gross receipts taxes are commonly criticized for being non-transparent taxes. While businesses are legally required to pay gross receipts taxes, in many cases the economic burden of them is passed forward to consumers in the form of higher prices. Yet unlike retail sales taxes, it is not possible for lawmakers to simply require gross receipts taxes to be itemized on printed sales receipts given to consumers, because it is not possible to directly observe the total amount of gross receipts tax that is "pyramided" into the final price of goods. As a result, consumers routinely bear the burden of gross receipts taxes without any knowledge that the tax is being imposed on them.

This lack of transparency is not simply the result of poor tax design by lawmakers. It is an inherent feature of gross receipts taxes. Imposing non-transparent taxes that disguise the true cost of spending programs may be politically advantageous to lawmakers, but in a democratic society that requires informed citizens, it is poor tax policy.

The difference between a 1 percent and a 2.53 percent effective tax rate illustrated in Table 1 may appear unimportant. But even small differences in effective tax rates can have dramatic consequences over time. Investors in the economy are sensitive to rates of return in different industries, and small differences in effective tax rates can mean the difference between starting a company in one industry and abandoning another. Over time, variations in effective tax rates caused by tax pyramiding have the potential to distort investment patterns in the economy for the worse, altering the industrial landscape of state and local economies over time.

Attempts to Reduce Tax Pyramiding Lead to Tax Complexity

In practice, the problem of tax pyramiding is well understood by lawmakers. Most gross receipts taxes attempt to mitigate tax pyramiding in some way. The two most common methods are (1) offering tax credits, deductions and exemptions to industries with high levels of pyramiding, and (2) enacting differential tax rates for different economic sectors based on estimates of tax pyramiding throughout the economy.

For example, Washington State's Business & Occupation (B&O) Tax was enacted in 1935 with a uniform rate of 0.25 percent on all industries. As revenue demands forced up tax rates over time, concerns about the inequity and inefficiency of the tax prompted lawmakers to enact separate rates for various industries, along with a range of targeted tax incentives. By 2005, lawmakers had enacted six separate tax rates ranging from 0.138 percent to 1.6 percent based on industry, as well as 8 distinct tax incentive programs for the B&O Tax alone.[15]

All these attempts to reduce tax pyramiding have failed. Studies routinely find substantial tax pyramiding under gross receipts taxes, despite the best efforts of lawmakers.[16] This is not surprising, as no legislature is equipped to undertake the formidable task of continuously adjusting tax law to reflect changing estimates of tax pyramiding in the

[15] Washington State Department of Revenue, "Descriptive Statistics for Tax Incentive Programs: 2006 Report Covering Activity During Calendar Year 2005" (September 1, 2006). Available at http://dor.wa.gov/docs/reports/2006/DescriptiveStatistics2006.pdf.

[16] For example, studies of Washington State's gross receipts find substantial tax pyramiding, despite the state's differential tax rates and incentives. See Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State: A Report to the Legislature," Volumes 1 & 2 (November 2002).

economy over time. Instead, the main effect of lawmakers' attempts to mitigate tax pyramiding through differential rates and tax credits has been to sharply increase tax complexity—effectively abandoning the purported simplicity of gross receipts taxes.

In this way, gross receipts taxes pose a stark choice to lawmakers. They may enact either a simple tax that leads to economically harmful tax pyramiding, or a highly complex tax that does not. Unlike many other broad-based taxes, gross receipts taxes make it impossible for lawmakers to achieve both tax simplicity and economic neutrality.

Do Gross Receipts Taxes Punish Companies with Low Profit Margins?

Gross receipts taxes are based on business sales rather than profits. For this reason, they are often criticized for hurting low-margin, high-volume companies. For example, Washington State's 2002 assessment of its gross receipts tax concluded that the tax "[c]ontributes to a relatively large tax burden on low profit margin industries compared to other states."[1]

This is unquestionably true. The gross receipts tax may be simpler to administer, but it is not a neutral tax. High-volume, low-margin firms will generally carry a larger share of the tax burden, and perhaps diminish somewhat over time, in a state that switches from a corporate income tax to gross receipts tax. Meanwhile, firms with low volume but a high margin would pay a smaller share of the tax burden.

A simple example illustrates the problem. Consider two companies subject to a one-percent gross receipts tax: a low-profit-margin grocer, and a high-profit-margin software developer. As illustrated below, both companies initially have $1 million of sales. The grocer has a profit margin of 5 percent and earns $50,000 profit, while the software developer has a profit margin of 50 percent and earns $500,000. However, because both firms have identical sales, they pay the same amount of gross receipt tax—$10,000.

Gross Receipt Tax Burdens Are Unrelated to Company Profits

	Low-Margin Grocery Retailer	High-Margin Software Developer
Sales	$1,000,000	$1,000,000
Cost of Business Inputs	$950,000	$500,000
Profit	$50,000	$500,000
Profit Margin (Profit ÷ Sales)	5%	50%
Gross Receipts Taxes Due (One Percent Tax)	$10,000	$10,000
Gross Receipts Taxes as a Percentage of Profit	**20%**	**2%**

Source: Tax Foundation

When expressed as a percentage of profit, the low-margin grocer will pay 20 percent in gross receipts taxes, while the high-margin software developer will pay just 2 percent of profits. This has led many observers to criticize gross receipts taxes for imposing an inequitable tax burden on low-profit-margin companies.

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Tax Pyramiding Encourages Vertical Integration

Because gross receipts taxes result in tax pyramiding, companies have powerful incentives to cut the number of production stages for products by absorbing suppliers. By consolidating into larger firms with fewer taxable business-to-business transactions, industries can lower their effective tax burdens under gross receipts taxes. This consolidation of previously separate companies is known as "vertical integration."

For example, if the lumber and wood products industry in Table 2 were able to vertically integrate its four stages of production into a single larger company, the industry's effective tax rate on value added could be cut by more than half, from 2.53 percent to just 1 percent. In this way, gross receipts taxes provide powerful financial incentives toward vertical integration, even when doing so is economically wasteful from the perspective of society as a whole.[17]

Limits of Tax-Induced Vertical Integration

At first glance, one might imagine that gross receipts taxes might encourage entire industries to merge into a single large enterprise, avoiding all taxes on business-to-business transactions. However, there are limits to how much industries will consolidate in response to gross receipts taxes.

While companies can reap tax savings by vertically integrating under a gross receipts tax, those savings come at a price, because tax-induced integration generally makes companies *less efficient*. The reason is that prior to doing business in states with a gross receipts tax, companies will have already been pressured by competition to organize in the best possible way. If the imposition of a tax then entices

[17] For a detailed discussion of tax-induced integration see William F. Fox and Matthew Murray, "Economic Aspects of Taxing Services," *National Tax Journal* (March 1988), p. 28.

[18] See Appendix A for a mathematical illustration of this effect.

them to alter their structure for tax reasons, companies will suffer an efficiency loss as a result. That suggests industry consolidation under a gross receipts tax will continue up to the point where the tax benefits to companies of doing so just offsets those companies' efficiency losses from adopting poor organizational structures for tax reasons.[18]

This vertical integration caused by gross receipts taxes may benefit particular companies or industries by giving them an unwarranted tax advantage over competitors. But because this economic distortion shrinks the overall output of the economy, it is never profitable from the standpoint of society as a whole.

(continued from page 8)

However, despite this flaw of non-neutrality that is inherent in gross receipts taxation, there are two reasons to be wary of the criticism that this is "unfair," especially if the unfairness is explained in terms of the firm's "ability to pay."

First, ability to pay is a concept imported from the world of individual income taxation. It has no place in a discussion of business taxes.[2] The burden of gross receipts taxes is ultimately borne by consumers, workers and shareholders, not the companies themselves, so expressing gross receipts taxes as a percentage of profits does not measure companies' ability to pay. In fact, the workers, consumers and shareholders who actually bear the burden of the tax may be rich or poor, and that mix has nothing to do with the company's sales volume or profit margin.

Second, gross receipts taxes are not the only tax with this feature. Every non-income tax will result in tax burdens that are unrelated to profit margins, because they are not based on income. Retail sales taxes, property taxes, and cigarette and alcohol excise taxes all are paid partly by companies' shareholders and workers, but impose burdens that are unrelated to profit margins.

As a general rule, it is more appropriate to express the burden of a tax as a percentage of its base, rather than some other denominator. For example, retail sales taxes should normally be expressed as a percentage of sales, while income taxes should be expressed as a percentage of income. Because the base of gross receipts taxes is sales and not profits, expressing their burden as a percentage of profit can result in misleading comparisons with other taxes.

Despite these caveats, the criticism that gross receipts taxes unfairly ignore companies' profit margins is compelling to many who are accustomed to the comparative neutrality of an ideal corporate income tax. For this reason, it is easy to see why gross receipts taxes are viewed by many in the general public as unfair business taxes.

1 Washington State Tax Structure Study Committee, "Tax Alternatives for Washington State: A Report to the Legislature," Volumes 1 & 2 (November 2002).
2 The exceptions are companies organized as sole proprietorships and partnerships, in which the profits of the company are also the income of the individuals who may bear some portion of business taxes. Corporations do not have this feature. See "Reexamining the Federal Corporation Income Tax," *Tax Foundation Project Note* No. 42, p. 9 (January 1958).

Some Industries Taxed More Heavily Than Others

Because gross receipts taxes disturb the structure of companies, they have a secondary effect of creating wide disparities in effective tax rates on different products and industries. Industries that vertically integrate following the imposition of gross receipts taxes—as well as those that are naturally vertically integrated—face low effective tax rates, while those that remain decentralized face high effective rates. These arbitrary differences between tax burdens faced by industries have the potential to create large economic distortions throughout the economy.

In the simple case where taxes are assumed to be fully passed forward to consumers in the form of higher prices, different effective tax rates will affect consumers directly by making some products more expensive than others for tax reasons.[19] In the more complex case where the burden of taxes is split between owners of capital or workers, the movement of plant, equipment and workers from tax-disadvantaged industries into tax-advantaged ones will tend to magnify the economic harm of gross receipts taxes over time. Appendix A outlines a mathematical illustration of how gross receipts taxes fall unevenly on different industries in the economy, potentially distorting investment away from smaller and more efficient firms and toward larger, less efficient organizations.

Discrimination in Favor of Imports over Domestic Producers

In theory, well designed state tax systems should tax imports on the same basis as domestically produced goods, and they should exempt all exports from taxation, as they will be taxed as imports in other states. Under such a system, companies' decisions to import or export will be guided by economic forces rather than tax considerations. However, this interstate tax neutrality is impossible under gross receipts taxes.

[19] For a discussion of the effects of tax-induced changes in relative prices, see Fox and Murray, *op. cit.*, p. 29.

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Ohio 2020 Tax Policy Commission Testimony

Submitted by Steve Bowser, Bowser-Morner, Inc.

Thursday, November 19, 2015

Good morning and thank you for this opportunity to offer our company's thoughts and perspectives on Ohio's business tax system. Bowser-Morner is a commercial testing and engineering company, and we employ 135 engineers, scientists, technicians, and administrative personnel. Key clients include regional and national manufacturers and construction materials producers, and owners, designers, and builders of commercial, industrial, transportation, energy, and institutional facilities. Our headquarters are in Dayton, OH with offices and laboratories in Toledo, OH; Lexington, KY; Springfield, IL; and Birmingham, AL. About 85% of our employees live and work in Ohio. The operating company is a C corporation, and we also have two LLC's which lease real estate and equipment to the operating company. I am also here as a member of the National Federation of Independent Business/Ohio (NFIB/Ohio) Leadership Council.

Overall, the changes to Ohio's tax system over the last several years have been beneficial to our business, allowing us to continue investing in our people, facilities, and equipment during challenging economic conditions.

- The elimination of the Ohio Franchise and Personal Property taxes along with the institution of the CAT tax were probably neutral to us, but helpful to many of our large clients here in Ohio. As you know, we pay 0.26% of our Ohio sales in CAT tax. For comparison, Illinois has an 8-10% income tax on corporations and pass through entity owners, Kentucky' s rates are 4-6%, and Alabama has a 6.5% rate plus a net worth tax.
- We have 70 company trucks which transport our people and equipment to construction and environmental sites in Ohio and surrounding states. As our fleet has become more fuel efficient and our total miles driven has declined, we are paying less in fuel tax than before the Great Recession. We pay a little less than 0.2% of sales in Ohio fuel tax, mostly at the $0.28/gallon rate for gasoline. The other states in which we operate have lower fuel taxes, ranging from $0.16/gallon in Alabama to $0.26 in Kentucky.
- One of our LLC's owns our facilities in Dayton and Toledo, and we pay about 0.8% of sales in property tax. These taxes have been reduced over the last few years due to declines in the property values, and range from 3-4% of appraised value. Although we don't own real estate outside Ohio, the rates at our other locations are lower, ranging from 0.5% in Alabama to 2.5% in Illinois.
- The recent personal income tax exclusions for pass through entities such as our LLC's along with the reductions in the actual tax rates have made Ohio a more favorable place for our higher paid employees and for our real estate and equipment investments. We also plan to lower our lease renewal rates if the tax exclusions become permanent, making our business more competitive with large, out of state companies. As mentioned above, these current tax policies for pass through entities compare very favorably with the other states in which we operate.

- While we appreciate the recent reforms to Ohio's municipal tax system, this tax remains problematic for us. We met with our CPA last week, and expect to file 50-60 local tax returns for the 2015 tax year. The typical return costs us more to prepare and file than the amount of tax due. Ohio is the only state where we have to track and pay municipal taxes outside the cities where we have facilities, and remains an uncompetitive feature of our tax system.
- By far the largest tax we pay is the sales and use tax, which we pay on most of our purchases in Ohio, including equipment purchases and leases, project and office supplies, and most services except legal, accounting and other professional services. We pay about 2% of our sales in sales and use tax, mostly at a 7.25% rate. For comparison, we pay an 8.5% rate in Illinois, but no services are taxed, 6% in Kentucky, and 10% in Alabama. An interesting feature of Alabama's sales tax is that it is roughly half the normal rate for truck and auto purchases and leases. It is also important to note that none of the states in which we operate impose sales or use taxes on professional business services such as legal, accounting, training, consulting, engineering, and testing laboratories.

Overall, we estimate we pay 3.5% of revenues in various state and local taxes, which we believe is competitive with the other states in which we operate. Please note that if we achieve our operating profit goal of 10% of sales, our state taxes amount to 35% of our profits.

Our biggest concerns at this point relate to the recent proposals to broaden the state sales tax base to include real estate transactions and leases, and many professional services. Many of our clients have their own laboratories, scientists, and engineers, and if we were required to collect a 7%+ sales tax from them, they would have an incentive to bring our work in-house. We also compete with many out of state companies who could do engineering and lab work outside Ohio and potentially avoid collection of the sales tax.

While we applaud the effort to continue reducing Ohio's income tax rates, we urge caution in expanding taxes on business to business transactions. Such expansions could have the unintended result of reducing opportunities for smaller companies by making their services more costly to larger customers who could bring the work in house. There is also the risk of making Ohio based real estate and professional service providers less competitive with other states which do not tax these services. Lastly, new taxes on business to business transactions inevitably make those businesses less competitive by the amount of the new taxes.

Thank you again for this opportunity, and I will do my best to answer any questions you may have.

JobsOhio

December 15, 2015

Ohio 2020 Tax Policy Study Commission
Testimony of John Minor, JobsOhio President & CIO

Chairman Peterson, Chairman McClain and members of the Ohio 2020 Tax Policy Study Commission my name is John Minor, I am the President and Chief Investment Officer at JobsOhio. Thank you for inviting me to testify today.

JobsOhio is a non-profit company designed to drive job creation and new capital investment in Ohio through business attraction, retention, and expansion efforts.

At JobsOhio, we have a unique model through the privatization of our company and our funding. Our private sector approach includes a strategic focus to business development, and I will highlight a few key elements to this model.

First, we target industries that help drive the state's economy and provide job growth opportunities; industries like advanced manufacturing, biohealth, food processing, IT, automotive and aerospace, financial services and shale energy.

Second, we are client-centric and foster lasting relationships with companies inside and outside of Ohio; we recognize the importance of our clients, which are the companies that are growing and creating jobs; so we put these clients at the center of our activities, including marketing and sales as well as project management and project finance.

Third, we develop strong partnerships with various players in economic development, including county and city officials as well as our network of six regional partners. Combined, these partnerships provide the connectivity to achieve a 'One Firm, One State' collaborative approach. We recognize the importance of leveraging these partners and their local knowledge and experience and relationships.

At our Board meeting last week, we highlighted a project that involved the attraction of Italy-based Sofidel Group, a global manufacturing company that is locating its first U.S. greenfield project in Circleville and creating more than 300 jobs and investing more than $250 million in capital assets. In addition to the JobsOhio team, this effort included key contributions from Columbus2020, Pickaway County and its community leaders, utility companies, Ohio EPA and ODOT among others. This is a great example of this 'One Firm, One State' approach.

We continue to build-out our JobsOhio team, which has grown to close to 70 associates. In addition to marketing, sales, project management and finance, we have research, accounting, legal and compliance, and industry teams. On our industry teams, we have sector experts that have significant knowledge and experience in our targeted industries. One of the things of which I am most proud is the JobsOhio team, I would put this group up against any other development organization.

Combining all of this with our long-term funding stream aligns our business development activities with the strategic plans of companies with whom we work, and allows us to offer a value-added proposition to these companies; this resonates well with their CEOs and other senior management and gives us a competitive advantage.

In our early years, we have proven that this model works. Our success is due to our strong Board of Directors and talented team of associates. We have had a good balance of projects with companies of various sizes, including large corporations that have established presence in key industries, middle market companies which are creating the majority of the jobs in our projects, and small businesses which are the innovators and drivers of future job growth.

For example, Rep. McClain you might recall that we announced the expansion of AJM Packaging Corp. in Bellevue with 150 new jobs. Rep. Schuring – you might remember the recent expansion of Stolle Machinery in Jackson Township with the creation of 42 jobs and retention of 80 jobs. Rep. Cera – you know the work that we have done in Belmont County with PTT Global Chemical. And Sen. Tavares – you might recall Coyote Logistics here in Franklin County, which merged with another company and considered moving operations to two other states.

I look forward to discussing how to maximize Ohio's competitiveness with you. At this time I am happy to respond to questions from the committee.

Testimony Before the 2020 Tax Study Commission
Brandon Kern, Director of State Policy
December 15, 2015

Members of the 2020 Tax Study Commission, thank you for inviting Ohio Farm Bureau to offer the agriculture's perspective on tax policy in the state of Ohio. Farm Bureau shares the goal of ensuring Ohio's tax code puts our state in the most competitive position possible. We applaud the establishment of this committee in order to take a long-term approach.

Farm Bureau Approach to Tax Policy

When considering the full spectrum of taxes, Ohio Farm Bureau members have crafted a policy that ranks each tax from most palatable to least. Because of the nature of how each tax impacts production agricultural directly, the state's income tax is the most palatable tax under our policy followed by the state sales tax, the commercial activity tax (CAT) and then local property taxes as the least palatable. Given this policy, Farm Bureau takes a holistic approach when viewing tax proposals. We consider the overall impact of changes to how our members are taxed along with the overall benefit to Ohio's economy. This policy allows Farm Bureau to support or oppose tax reform proposals that take on a number of different forms.

For example, even though our policy indicates income tax is the most palatable tax, we can support reducing the income tax if it's done as a part of tax reform that does not raise taxes in the least palatable categories. However, if cutting income taxes comes at the expense of increasing other taxes or implementing policies that encourage local governments to seek more funding from property taxes our evaluation would be different. So for example, in the holistic approach we take, inadequate education funding could potentially impact our overall stance on tax reductions.

Income Tax

In alignment with the holistic approach I outlined above, we have supported the goal of reducing income taxes in Ohio because we believe it helps Ohio's overall economy. A better economy benefits agriculture as well. Farmers across the state have organized their businesses as pass-through entities for the many benefits they provide such as liability protection and workable options for passing their farms on to the next generation. When income tax reductions are targeted toward small businesses such as these, it provides an even bigger benefit for Ohio's economy.

Sales Tax

In accordance with the principle that sales tax is not meant to be levied on a product's input or production components, purchases of products directly used in production agriculture are exempt from sales tax. As a result, agriculture isn't impacted as much as many other types of businesses when increases or decreases in the sales tax are debated.

and not the worth of its development potential. The formula is highly complex and incorporates factors such as soil type, cropping history, crop prices, yields, non-land production costs and interest rates. Generally, the formula estimates the net income that can be derived from typical farmland, multiplied by a capitalization rate that simulates the effects of financing the land and the purchaser's expected return.

The CAUV program has been extremely effective and a critical program that conserves farmland for over 40 years now. CAUV is, in fact, Ohio's most effective tool for preserving farmland. Many landowners could simply not afford to keep farming their land without CAUV. As you know, voters felt so strongly about the importance of this program, that they amended Ohio's constitution in 1973 to ensure it would continue to provide a fair way of taxing the land that produces the food we all eat.

Farm Bureau has always dedicated significant time and resources to ensure our organization has a firm understanding of the formula, mainly for the purpose of providing a membership benefit in the form of educational outreach to OFBF members. However, over the past year-and-a-half Farm Bureau members directed our organization to conduct a deeper analysis of the program. This was in response to skyrocketing CAUV values, which have exponentially increased over that past seven years.

Most farmers understand and accept the fact that higher commodity prices we experienced from around 2008 to 2013 would result in higher use values for their land. However, it's the amount of increase that has been hard to understand and accept. The statewide average CAUV value increased 292% from 2008 until 2014. Commodities prices haven't come close to keeping pace with that growth. So, it's clear to many of our members that something else in the formula is intensifying increases in use value.

We organized a study committee made up of tax experts, lenders, appraisers and OSU Extension. We also consulted with government entities such as USDA's National Resource Conservation Service, the USDA's National Agricultural Statistics Service, the Ohio County Auditor's Association and the Department of Taxation.

We found the overall methodology used in the CAUV formula was sound. However, we did find that some individual components needed to be updated to reflect the modern agricultural economy. More importantly, we found that other factors, added to the formula over time, were serving to allow real estate market factors to inflate CAUV values even more than what should occur based on the 2008-2013 period of commodity price increases.

Based on our findings, we issued two rounds of recommendations on changes to improve the accuracy of CAUV. None of our recommendations aims to arbitrarily cap or reduce the amount of taxes farmers pay. Rather, our proposals have focused on ensuring the program is an accurate measurement of agricultural use.

The first round of recommendations, issued in the fall of 2014, were a series of simple updates that could be made by the tax department under the tax commissioner's administrative authority.

OHIO FARM BUREAU

Forging a partnership between farmers and consumers.
•Working together for Ohio's farmers•

Ohio Farm Bureau Federation
Testimony on the Agricultural Sales Tax Exemption
Before the Senate Ways and Means Committee
Brandon Kern, Director of State Policy
March 11, 2015

Thank you Chair Peterson, Vice Chair Beagle, Ranking Member Tavares and members of the Senate Ways and Means Committee for the opportunity to offer testimony on Ohio's agricultural sales tax exemption. We appreciate the thoughtful review of tax expenditures the Senate is conducting. Farm Bureau shares your goal of ensuring Ohio's tax code puts our state in the most competitive position possible.

Agriculture's sales tax exemption is a critical component to creating a business environment in Ohio that allows agriculture to produce the food we all consume. The exemption is narrowly defined, and serves to uphold the objective that a sales tax is not meant to be levied on a product's input or production components.

The application of sales tax to input costs of a capital intensive, low profit industry such as agriculture would have significant and severe consequences. Farm Bureau strongly believes the *sale tax exemption must be preserved*.

When you look at agriculture in our state, it's easy to associate recent historically-high commodity prices and increasing yields with good times for Ohio's farmers. However, as we have been reminded recently, the commodity market can be a volatile place, subject to large swings in prices. Those record high commodity prices that peaked in 2012, have tumbled since. A farmer selling corn last year, for example, on average fetched about half of what she did two years prior.

This recent slide in prices is one thing, but cost of inputs for farm operations is an even bigger concern to many farmers across the state. If you don't farm, you may not think about all the input costs that farmers incur in order to produce the food we eat. But the fact is, agriculture is a highly capital intensive industry with significantly low profit margins. Those profit margins are even thinner for smaller farms. In fact, over 69 percent of U.S. farms operate in USDA's "critical zone" indicating potential financial strain. Farms operate in the critical zone if operating profits comprise less than 10 percent of the farm's gross cash farm income (GCFI). I have attached an explanation of GCFI and USDA's analysis to our testimony.

High production costs are a major driver of narrow profit margins in agriculture. To demonstrate how application of the sales tax input cost would impact production, we have provide the model below. These statistics are based on statewide average costs compiled by The Ohio State University's Department of Agriculture, Environmental and Development Economics. They are receive for the meat, eggs, cheese, grain and milk that go into each breakfast. We do this to demonstrate how little the cost of food is attributable to those who grow it.

While I would like to tell you applying the sales tax to agricultural inputs would be passed on to consumers in the form of higher food costs, I can't use that scare tactic. We can't play that card because it simply isn't true at least not immediately. For farmers, the reality is even more damaging. Because prices are dictated by commodity exchanges and global demand, increased costs associated with applying sales tax to inputs will largely be eaten by farmers. Considering the profit margins we operate on, one can't help to think this would very likely drive some farms out of business.

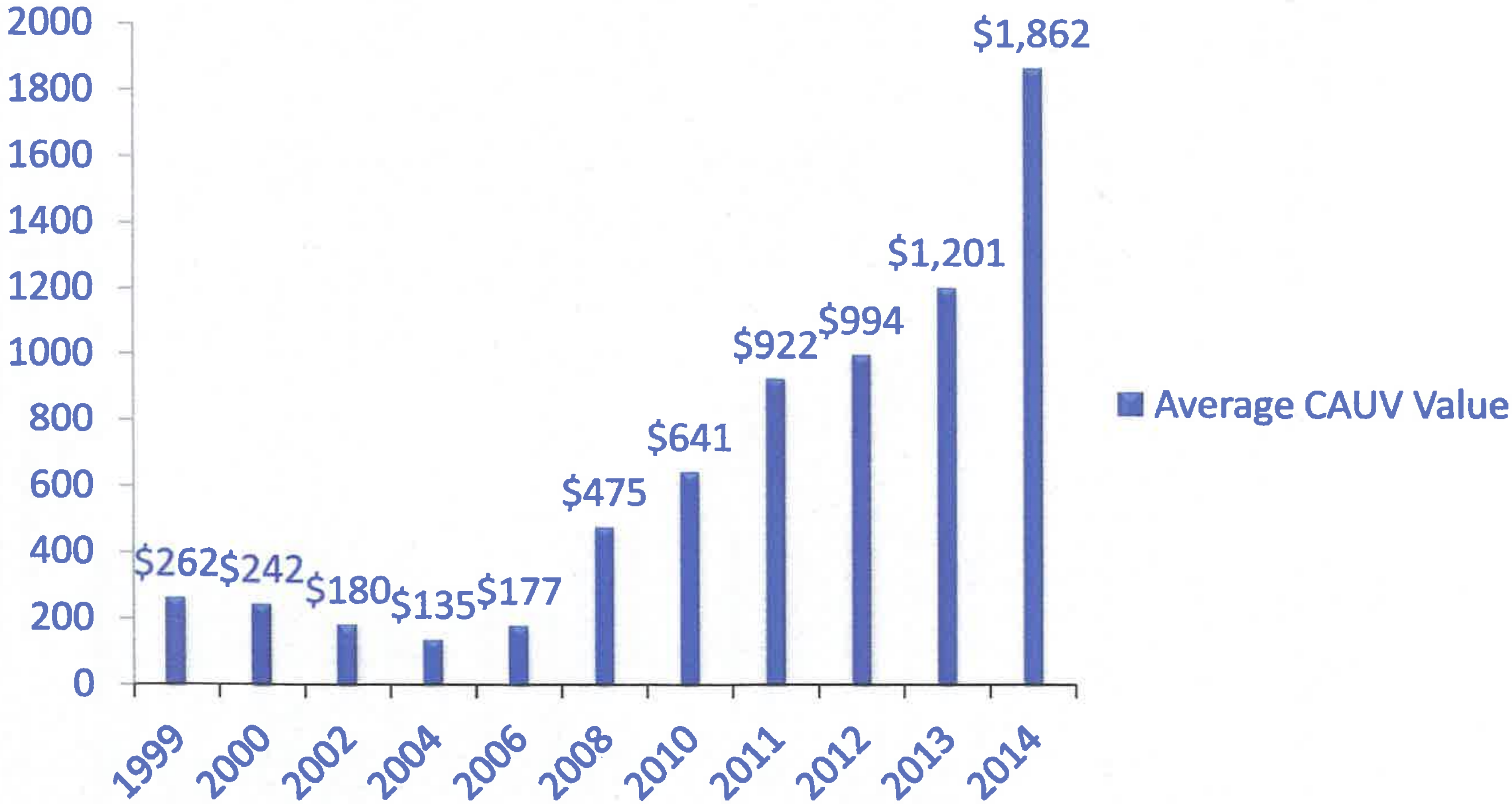
Getting food from field to fork requires growers, commodity handlers, food producers and logistics to connect all of those processes. Another important merit of the exemption is that it ensures compliance with the intent of the sales tax, which is to tax consumption. If you think about all the stops that food makes on its way through the production process, the impact of compounding tax is also a real concern.

Finally, the exemption is narrowly defined, is very difficult to abuse as implemented and meets the legislative intent under which it was created. It is structured so that the only items purchased are those for use in the production of agricultural goods. The use of this exemption is strictly enforced. Farmers must provide a properly completed exemption certificate to their vendor and the vendor must retain the certificate as proof of the nontaxable sale. It is the obligation of the farmer to prove the purchases are being used directly in the production of a product for sale. Items that are exempt include seeds, fertilizers, pesticides, field tiles, tractors, plows and combines. The exemption does not include almost all motor vehicles licensed to operate on the highway, lawn mowers and items used to maintain set-a-side fields.

The sales tax exemption is a vitally important component of Ohio current tax code. It provides guards against compounding tax on food production and recognizes input costs for farms are not end consumption. It is prescriptive, and Ohio regulations provide appropriate levels of accountability to prevent abuse. Farm Bureau urges the committee and the legislature to recognize these benefits and preserve Ohio's agricultural sales tax exemption.

Thanks you again, Mr. Chairman, for the opportunity to appear before the committee. I would be happy to answer any questions from committee members.

Average CAUV values since 1999



May 12, 2015

Commissioner Joseph W. Testa
Ohio Department of Taxation
P.O. Box 530
Columbus, Ohio 43216- 0530

Re: Current Agricultural Use Value

Dear Commissioner Testa:

I am writing to express my sincere thanks to you and your staff for being responsive to the needs of Ohio's farm community by enacting Ohio Farm Bureau's first set of recommended changes to the current agricultural use value (CAUV) formula. As I have stated before, CAUV is a vitally important property tax management and farmland preservation tool for farmers and all Ohioans.

Since my last letter to you in November, we have continued our intensive research into additional areas of the CAUV formula in need of modernization and improvement. During the most recent meeting of your department's Agricultural Advisory Committee on March 5, 2015, my staff shared with your staff and the Committee an overview of Ohio Farm Bureau's continuing research and areas of focus. We have identified and recommend additional adjustments to the formula that you can implement for the 2015 values that would continue to improve and strengthen the formula to the benefit of all Ohioans. These adjustments include:

1) Removing non-farm influences from the formula by using the simple Band of Investment mortgage-equity appraisal method in place of the Akerson method to determine the capitalization rate. The Akerson method uses a projected holding period for the "investment" (i.e. the land) which is currently set at 5 years. In other words, the Akerson method assumes the farmer will own the land for only 5 years, which we believe is entirely inaccurate. Farmland in Ohio is typically held for decades, and is frequently passed from one generation to the next. Because of this, it is not appropriate to use such a relatively short-term holding period as is currently utilized by the Akerson method. Likewise, the Akerson method considers equity buildup, whereas the Band of Investment method does not. Equity buildup should not be considered in determining agricultural use value, as land becomes no more or less agriculturally productive as the borrower pays

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Ohio Farm Bureau remains committed to finding additional solutions that will not only improve and modernize the CAUV program, but will also preserve its integrity and purpose. To that end, we are continuing to explore the following additional concepts, the first four of which were raised at the March 5th meeting of the Agricultural Advisory Committee. We welcome the opportunity to explore the following concepts with you further.

The concepts under continued review include, first, improving the accuracy of values for lower-productivity soils by lowering the minimum values to an ultimate low that will remain constant. Only the least productive soils, and those soils with a slope of 25% or more, are set at this minimum value. Generally these soils will have severe limitations which inhibit the soil's agricultural productivity. Over recent years, these least productive soils have seen significant increases in the minimum values established by the Tax Department without corresponding gains in productivity. We are concerned about these increases in minimum value which are not directly driven by factors in the formula such as improved yields or crop prices and therefore do not accurately reflect current agricultural use value for these soils.

Second, we continue to explore ways to better preserve Ohio's most vulnerable farmland by adjusting the statewide average millage rate used for the tax additur to better reflect higher millage rates in effect for farmland near urban development. The current CAUV formula uses a statewide average effective tax rate on agricultural property in the calculation of the statewide capitalization rate. Accordingly, the average is weighted more heavily toward the effective tax rates in rural areas with lower millage rates. This harms the owners of the most vulnerable farmland in more developed areas with higher millage rates, because their actual millage rate (and therefore their actual property taxes) are much higher than what the formula assumes. By way of example, the 2014 statewide average effective tax rate on agricultural property used in the calculation was 49.58 mills, while farmland in more urban areas with significant development pressure may have effective tax rates between 70 to 100 mills.

Third, we are reviewing the concept of reincorporating a risk management factor into the formula, as dictated by the Ohio Administrative Code. A risk management factor will help to better represent the increased variability in production that occurs as soils are less naturally productive, resulting in lower and more accurate values on less productive soils.

Fourth, we are reviewing whether a minimum capitalization rate should be established similar to the minimum values which have been established by the Tax Department. Other states have established minimum capitalization rates which have helped to mitigate the impact of artificially low interest rates experienced over the past several years.

BEFORE THE 2020 TAX POLICY STUDY COMMISSION OF THE OHIO GENERAL ASSEMBLY

SENATOR BOB PETERSON AND REPRESENTATIVE JEFF MCCLAIN

CO-CHAIRMEN

TESTIMONY
OF
MARK ENGEL
BRICKER & ECKLER LLP
OMA TAX COUNSEL

JANUARY 20, 2016

Mr. Chairman and members of the Committee, my name is Mark Engel. I'm the Partner in charge of Bricker & Eckler's Cincinnati-Dayton office; my practice is focused on taxation issues, with concentrated experience in all aspects of state and local taxation, including tax planning, compliance, and litigation in sales and use, income, commercial activity, public utility, and property taxation as well as economic development. I also serve as tax counsel for The Ohio Manufacturers' Association (OMA). I'm testifying today on behalf of OMA. The OMA was created in 1910 to advocate for Ohio's manufacturers. Its mission is to protect and grow Ohio manufacturing.

For Ohio to be successful in a global economy, the state's tax structure must encourage investment and growth and be competitive nationally and internationally. A globally competitive tax system is characterized by (a) certainty, (b) equity, (c) simplicity and (d) transparency. Economy of collections and convenience of payment also are important considerations.

Generally, manufacturers support efforts to broaden the business tax base, which enables lower rates. To preserve the integrity of the broad tax base and ensure fairness, credits and exemptions should be reduced and discouraged. The objects of taxation must be clearly defined. Where needed, government incentives are best structured as grants rather than as tax credits. And, in general, earmarking and dedicating general tax revenues to specific purposes should be discouraged.

It is poor tax policy to single out any one segment of the economy or group of taxpayers to bear the cost of tax relief for the general population. Similarly, except to resolve existing inequality, or in cases of other policy imperatives, Ohio tax policy should not create a windfall for any group of taxpayers at the expense of other groups of taxpayers.

Compliance and administration of any tax should be as simple and inexpensive as possible for taxpayers and tax administrators alike.

Good tax policy also generates necessary revenues to support the essential functions of government. To ensure transparency regarding the true cost of government and the rate of its growth, however, funding government programs with fee revenue instead of general fund revenue should be discouraged. Good budgeting and spending restraint at all levels of government are vital to ensure a competitive tax environment.

Major tax reforms approved by the Ohio General Assembly in 2005 and additional reforms from 2011-2015 have led to significant improvements to a tax system that was for many years widely regarded as outdated. Reforms included reducing overall tax rates, eliminating tax on investment, broadening the tax base, providing more stable and predictable revenues, and simplifying compliance.

The elimination of the tangible personal property tax, the corporate franchise tax, and the estate tax has strengthened the competitiveness of Ohio's tax system. So has the reduction of the personal income tax rate as well as the creation of a broad-based, low-rate commercial activity tax.

2005 Tax Reform

Prior to 2005, Ohio's tax structure was essentially unchanged since the 1930s. At that time, Ohio's economy was driven by agriculture and manufacturing. Its tax structure reflected that economy. The major taxes were the real property tax, the sales and use taxes, the tax on tangible personal property used in business, and the corporation franchise tax measured on net worth. However, the franchise tax and the tangible personal property tax, especially, both hit capital-intensive industries harder than others and had to be paid whether the entity made, or lost, money. Thus, the manufacturing sector paid an inordinately high level of state tax when compared with other segments of the economy.

As services made up a larger share of Ohio's economy over the years, the inequality in the state tax burden between manufacturing and other segments of the economy was exacerbated. Many service sector concerns operate without a significant investment in capital; hence, their tangible personal property and net worth franchise tax liabilities were minimal. Many of these services can manipulate their finances to minimize income; as a result, little income tax was generated. In addition, many of these new service entities were organized as pass-through entities that were not subject to the franchise tax. As the demand for state services grew, the only recourse was to raise existing tax rates on existing taxpayers. In many cases, that meant an increasing tax burden for Ohio manufacturers.

Paradoxically, Ohio continued to add exemptions from, and exceptions to, the various taxes during this time. As a result, Ohio was saddled with a number of taxes that had high nominal rates, but struggled to raise sufficient levels of revenue for governmental operations. The discrepancies between taxpayers and economic segments also increased and compliance with the existing taxes became more complicated.

Calls for Reform

During the 1960s, calls for reform in Ohio's tax structure began. Over the years, various band aids were applied to Ohio's tax structure in order to attempt to reduce its inequalities. At the same time, Ohio continued to enact exemptions from, or exceptions to, the various taxes, thereby creating increasing disparity and complexity.

With the dawn of a new millennium, calls for tax reform increased. Dr. Ned Hill of Cleveland State University independently conducted a study that examined the impact of state tax policy on Ohio's economy and called for the elimination of the tangible personal property tax and existing dual-based franchise tax, to be replaced with a broad-based, low-rate tax based on payroll. The study demonstrated how capital-intensive segments of the economy, such as manufacturing, construction, and mining, paid anywhere from three to 11 times more state taxes than did members of many service industries.

Tax Reform Enacted

Finally, in early 2005, true tax reform was proposed. The goals of tax reform were:

- Eliminate tax on investment and shift to the taxation of consumption;

- Broaden the over-all business tax base;
- Reduce over-all business tax rates;
- Provide a more stable and predictable flow of revenue; and
- Simplify compliance.

The result was a comprehensive overhaul of Ohio's tax system by H.B. 66. As enacted, the bill:

- Eliminated the tangible personal property tax on new investment in manufacturing and phased out the tax on all general business property over 4 years;
- Phased out the corporation franchise tax for most corporations over 5 years;
- Phased in a 21 percent reduction in personal income tax rates ratably over 5 years (the last reduction was delayed 2 years in 2009 in an effort to balance the state budget, but was implemented in 2011); and
- Enacted the commercial activity tax ("CAT"), a broad-based, low-rate tax measured by gross receipts from virtually all business activities and entities.

H.B. 66 became law in June 2005. Although generally opposed to gross receipts taxes because of their compounding nature, the broad base due to limited exclusions and the low rate caused many skeptical taxpayers to warm to the tax as the net savings over the former franchise and personal property taxes became clear. In addition, compliance costs were slashed as taxpayers no longer had to undertake the arduous process of preparing personal property tax returns or corporation franchise tax reports.

Results of Tax Reform

Due to the phased implementation of the provisions of H.B. 66 and the general economic slowdown that has gripped the country over the past few years, questions have been raised regarding the effectiveness of the tax reform efforts. OMA has been at the forefront in demonstrating that, indeed, the effort was worthwhile.

- In 2009, Ohio won Site Selection magazine's "Governor's Cup" for an unprecedented fourth consecutive year. The Governor's Cup is awarded annually to the state having the most major business expansions in the nation.
- A January 2009 Ernst & Young study indicated that Ohio's business tax burden rated between 18th and 23rd best among states on three different scales of comparison. Another Ernst & Young study conducted for the Ohio Business Development Coalition showed that Ohio had the lowest effective tax rates on new capital investment in the Midwest.
- The Small Business & Entrepreneurship Council's Business Tax Index in 2008 rated Ohio's state tax system as 14th best nationally.

- In March 2010 the Federation of Tax Administrations released an analysis of new data from the U.S. Census Bureau showing that for FY 2009, Ohio's per capita state tax burden was the 16th lowest; as a percentage of personal income, the burden was the 18th lowest.
- In April 2011, Ernst & Young and the Council on State Taxation issued a report entitled "Competitiveness of State and Local Business Taxes on New Investment" in which they concluded that Ohio had the third lowest rate of state and local taxation on new business investment. The report laid this result directly at the feet of the 2005 tax reform law.
- In early 2013, Site Selection Magazine honored Ohio as having the 5th most favorable tax climate for mature firms and the 3rd most favorable tax climate for new firms for fiscal year 2012.
- Finally, according to the Ohio Department of Taxation, Ohio is one of only six states that do not tax corporate profits, and one of 10 that do not tax business personal property.

Commercial Activity Tax

Much has been debated regarding the commercial activity tax (CAT). For manufacturers, while the tax is not perfect, it has done much to spur growth and investment in Ohio's largest industry.

According to Ohio Department of Taxation Fiscal Year 2014 Commercial Activity Tax Returns data, manufacturers made up the second-largest group of CAT taxpayers, representing 10.2 percent of all taxpayers (retail trade is the largest).

And, manufacturers pay 26.8 percent of the state's total – far more than any other group (in terms of CAT revenues based only on the 0.26 percent CAT rate for gross receipts in excess of $1 million).

In addition, CAT filers with taxable gross receipts of $1 million or less accounted for 66.7 percent of all filers in fiscal year 2014, but only 0.7 percent of the total liability for that period.

As noted above, some of the most important aspects of the CAT are its broad base, its low rate, and its broad application to business entities. Those attributes can only be maintained when the state stands firm against pleas for individual carve-outs and exemptions.

When it was first enacted, there were few exclusions from the CAT and only four credits. The tax expenditure associated with those exclusions in 2009, the first year the tax was fully phased in, was approximately $300 million. Those exclusions were built into the tax as enacted and the 0.26 percent rate was established with those exclusions in mind.

In its fiscal year 2014 tax expenditure report, the Department of Taxation lists a larger number of exclusions and credits to the CAT. The total cost of those expenditures is over $600 million! Thus, in just 10 years, additional credits and exclusions were added to the tax that doubled the amount of the tax expenditure.

The CAT is a stable tax. Although it is a gross receipts tax that pyramids along the economic chain, it is tolerated because of its broad base and low, low rate. However, in less than 10 years, tax expenditures associated with the tax have doubled. One wonders how much longer chipping away at the base can continue before the calls to increase the rate become too loud to ignore. Ohio traveled down this path before with the franchise and personal property taxes. The trip was a disaster. Ohio should not venture down that path again with the CAT.

The CAT was enacted as a tax on commercial activity. All enterprises engaged in such activity should be paying the CAT; in fact, equality in the burden of taxation demands that they all remain subject to the tax.

Personal Income Tax

As noted earlier, sound tax policy dictates that any tax should have a broad base, a low rate, and few exclusions in order to minimize economic distortion. OMA applauds recent efforts to reduce Ohio's personal income tax rates. However, it is concerned that those efforts have typically been tied to a proposal to increase the sales tax, particularly on business consumption. This tax-shifting is not beneficial and may be counter-productive as businesses and consumers adjust to higher and higher sales tax rates. Rather, if income tax rates are to be reduced further, exclusions and exemptions from the personal income tax ought to be re-examined. If rates are reduced, the need for those exclusions and exemptions disappears. This would provide a broader base and a lower rate for all taxpayers, reduce overall taxes, and avoid the problems of tax-shifting.

Ohio currently relies upon a number of taxes of general application to fund its operations. Tax-shifting and other efforts to reduce or increase reliance on any of those taxes should be considered with great caution. One only needs to consider the crisis in Nevada in 2008, or the current crisis in Alaska, to recognize the problems of over-reliance on any one tax. Just as a broad base is important for any single tax, a broad base of general taxes is equally important for the fiscal welfare of Ohio.

Sales and Use Taxes

Ohio's sales tax was first enacted as a temporary measure in the depths of the Great Depression in the 1930s. At that time, it was conceived as a tax on final personal consumption of tangible goods. One year after initial enactment, the use tax was enacted; the two taxes were made permanent and the first exemption for machinery and equipment used to produce tangible personal property for sale by manufacturing was added. Similar exclusions were made for other activities that, similarly, resulted in the production of goods that would be subject to the tax upon final sale.

The rationale for these exclusions is simple: The taxes are intended to be imposed upon the final consumption of goods and, now, those selected services that are subject to tax. Intermediate transactions prior to the final sale of the product, including the acquisition of machinery and equipment and the raw materials that are incorporated into the final product, are not intended to be taxed. The basis for this is four-fold:

First, imposing the tax on intermediate transactions (sometimes called business inputs) causes the tax to be imposed at each step in the production of a good. This causes the tax to pyramid at each step of the economic ladder, resulting in an effective tax rate that may be much higher than the statutory rate. For example, in conjunction with the 1994 tax study commissioned by the General Assembly, the staff provided an example in which a sales tax rate of 6.5 percent applied to two stages of production resulted in an effective tax rate of 9.5 percent at the time of the final retail sale.[1]

Second, imposing the tax on business inputs increases the cost of doing business through the higher prices that result from the tax. Business generally will respond to higher costs in a combination of three ways: It may decide to charge higher prices; it may pay lower wages to workers (or expatriate those positions elsewhere); or it may provide a lower return on investment to owners.[2]

Third, direct inputs lead to the production of more valuable goods that are ultimately subject to the tax.

Fourth, the provision has economic development implications. Every single state that surrounds Ohio has a sales tax. Every one of those states has some sort of exemption from the tax for machinery and equipment used in the production of tangible goods to be sold by manufacturers. Moreover, the *1994 Study* also found that lower rates of taxation on business equipment increase the rate of business formation of smaller firms. Thus, imposing the sales tax on manufacturing machinery and equipment puts Ohio at a disadvantage from an economic development perspective.[3]

The application of sales and use taxes to business inputs has been the subject of comment on at least two prior occasions in Ohio. In 1982, the *Final Report and Recommendations of the Joint Committee to Study State Taxes* (114th General Assembly, December 1982), pp. 15-16 concluded that the taxes should be imposed broadly on consumer spending, but very selectively on business spending. Similarly, the *1994 Study* at p. 5-4 and the 1994 Staff Report at p. 27 both recognized that the sales tax should only be imposed upon the final consumer and that business inputs should not be taxed at all. The taxation of business inputs should be avoided because doing so leads to multiple levels of taxation and economic disadvantages. Moreover, the *1994 Report* concluded that if the sales tax is extended to services, there should be liberal exemptions for transactions between businesses.

However, this does not mean that manufacturers do not pay sales and use taxes in Ohio. Manufacturers purchase and use many goods and services that are not included in the manufacturing exemptions. Those items include machinery and equipment that is used before manufacturing begins, or after it ends; cleaning equipment and supplies; maintenance and repair equipment and supplies; storage facilities; most safety items; and office supplies and

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[1] Roy Bahl, Ed., *Taxation and Economic Development: A Blueprint for Tax Reform in Ohio* (Battelle press 1994), p. 277-278 ("*1994 Staff Report*.").

[2] *Taxation and Economic Development in Ohio: A Blueprint for the Future*, final Report of the Commission to Study the Ohio Economy and Tax Structure (December 23, 1994), p. iii ("*1994 Study*").

[3] *Id*., at p. 5-4.

equipment and motor vehicles. As a result, manufacturers pay millions of dollars in sales and use taxes annually to the state of Ohio.

According to the 2014 Annual Report of the Ohio Department of Taxation, manufacturers as an economic segment paid more than $410,000,000 in sales and use taxes directly to the state of Ohio. This is in addition to the untold millions of tax dollars that were paid to, and reported by, vendors and retailers located in Ohio. It appears that in terms of tax directly owed to the state, as opposed to tax that is collected from others, manufacturing is one of the largest payers of sales and use taxes in the state.

Since 2005, Ohio has attempted to move away from the taxation of business investment. It eliminated the tax on business tangible personal property. It eliminated the net worth base of the corporation franchise tax. And, it excludes from the commercial activity tax, receipts in the nature of a return on investment. As noted earlier in my remarks, the purchase of machinery and equipment by manufacturers is not final consumption. Rather, it reflects an investment in the business. The sales tax exemption for manufacturing machinery and equipment is consistent with this policy.

Imposing the sales tax on business inputs, including manufacturing machinery and equipment (and labor) is contrary to sound tax policy. As previous tax study commissions have concluded,[4] good tax policy is based on simplicity, equity, stability, neutrality and competitiveness. Removing the exemption and subjecting those purchases to tax will render the tax more opaque, more complex, and less fair as final consumers who are less economically advantaged will pay an even higher proportion of their family income in sales taxes. Removing the exemption violates the principles of neutrality and competitiveness as it results in higher costs, which may influence economic decisions and competitiveness. Taken together, all these factors may in fact render the tax less stable.

Exclusion of Tax on Services as Manufacturing Inputs

There are two specific cases in which the sales or use tax should be amended to exclude specific manufacturing service inputs. I'll briefly describe the recommendations:

Ohio does not impose sales or use taxes (or the CAT) on the wages paid to employees. Just as wages are not subject to such taxes; and business inputs, such as ingredients, machinery and equipment, are exempted from the sales and use taxes, so too should amounts paid for temporary employees engaged in manufacturing activities that are otherwise exempt from the tax. Such employees are a business input; the sales tax should not apply to transactions by which such labor is obtained.

House Bill 343 currently pending in the House would address this issue for all employers. However manufacturers have especially solid policy reasons for this exclusion.

Effective January 1993 in order to fill a hole in the state budget, employment services were added as a taxable service by a conference committee facing a midnight deadline to reach

[4] *1994 Study*, p. 5-1; *Report of the Committee to Study State and Local Taxes* (March 1, 2003), p. 6.

agreement on a new budget. A taxable "employment service" includes any transaction in which a person provides personnel to perform work under the supervision or control of another, whether on a short- or long-term basis, where the personnel are paid by the person who provided them. The entire amount paid for the service serves as the base on which the tax is calculated.

Many manufacturers assumed that the existing manufacturing exemption, which exempted purchases of machinery and equipment used to produce tangible personal property for sale in a continuous manufacturing operation, would also cover workers on the manufacturing floor that operated the exempt equipment. Manufacturers and other purchasers of employment services also believed that in appropriate circumstances the services would be resold. After protracted litigation, they were disabused of both notions.

Another area that served fertile for litigation was the exclusion for employees that were "permanently assigned" to the purchaser. As noted previously, there were two conditions to this exclusion. First, the employees had to be provided pursuant to an agreement of a least a year in duration. Second, the agreement had to "specify" that the employees were provided to the purchaser on a "permanent" basis.

This provision likewise resulted in a flood of litigation.

The Department of Taxation continues to pursue employment services aggressively. It argues that employee turnover is a sign that the employees are not permanently assigned. It also takes the position that an agreement must set forth the name of every single employee covered by the agreement, and that if any of the employees provided under an agreement are not provided on an indefinite basis, then the entire agreement is tainted and none of the employees qualify for the exclusion.

In recent audits, the Department takes the position that virtually any transaction involving personnel is a taxable employment service. Thus, transactions in which outside consultants are retained to provide services, such as computer and software design, engineering, or a skilled trade, are routinely picked up on audit as employment services.

The Tax on Employment Services Should Be Repealed

House Bill 343 proposes to do away with the tax on employment services completely. The bill deletes "employment services" from the list of taxable transactions in R.C. 5739.01(B)(3)(k); it deletes the definition of "employment services" found in R.C. 5739.01(JJ); and deletes reference to the provision in other statutes.

Repeal of this provision reflects sound policy.

First, repeal is consistent with the recent efforts of Ohio's tax policy to move away from the taxation of economic investment and towards personal consumption. Manufacturers invest in manufacturing machinery and equipment in order to expand or maintain their capacity to provide jobs and to produce a product for sale, a product that in most cases will be subject to the sales and use taxes when it is sold and used. Similarly, it invests in workers for the same reasons.

Since 2005, Ohio has attempted to move away from the taxation of business investment. It eliminated the tax on business tangible personal property. It eliminated the net worth base of the corporation franchise tax. And, it excludes from the commercial activity tax, receipts in the nature of a return on investment, including labor costs. Repealing the sales tax on employment services is consistent with this policy.

Second, imposing the sales tax on business inputs such as manufacturing machinery and equipment and labor is contrary to sound tax policy. As previous tax study commissions have concluded, good tax policy is based on simplicity, equity, stability, neutrality and competitiveness. Subjecting employment services to tax renders the tax more opaque, more complex, and less fair as final consumers who are less economically advantaged pay an even higher proportion of their family income in sales taxes. The tax on employment services violates the principles of neutrality and competitiveness as it results in higher costs, which may influence economic decisions and competitiveness. Taken together, all these factors may in fact render the tax less stable.

Just as wages are not subject to sales and use taxes; and business inputs, such as ingredients, machinery and equipment, are exempted from the sales and use taxes, so too should amounts paid for temporary employees engaged in manufacturing activities be excluded from the tax. Employees are a business input; the sales tax should not apply to transactions by which such labor is obtained.

Third, the provision has generated more and more litigation as the Department has taken increasingly aggressive positions with respect to it. The provision is neither clear, nor is it easy to administer.

An additional issue is that Ohio also taxes industrial janitorial and maintenance services. Manufacturers' production facilities and the equipment components of their production processes require continuous repair and maintenance. Without the required cleaning, repairs and maintenance the machinery breaks down and fails to produce acceptable products for sale to customers. Cleaning industrial assets is absolutely critical to the manufacturing process. It is a necessary business input and sales tax should not apply.

Severance Tax

While I am sure this commission will be taking a deeper dive into the severance tax issue, the OMA would like to take a couple of brief moments to touch on the issue.

The OMA recognizes that Ohio's current severance tax structure makes Ohio very competitive, one of the most competitive and drilling-friendly states according to provided data. We note the severance tax provisions in Ohio law, having first been enacted in 1971, are 40 years old and have not been materially updated. More extensive benchmarking of effective tax rates on the measure of energy severed would be helpful to inform policy decisions.

Even though new manufacturing investment does not qualify for cost recovery, the OMA recognizes the commonplace nature of cost recovery offered by other states to the oil and gas industry and does not object to some competitive level of cost recovery to spur new investment.

We note that a severance tax is an excise tax. An excise tax is typically upon a specified activity in order to help defray some special costs associated with that activity. In the case of the severance tax, those special costs might include regulatory, environmental, and health concerns, as well as infrastructure concerns for the communities in which the activity takes place. However, good tax policy demands that such a tax should not be used to fund a wide-scale reduction in some other tax of general application.

Conclusion

The OMA supports tax policy that supplies sufficient revenue for the execution of necessary state services in a manner that stimulates economic growth, investment and job creation. Tax policy should encourage growth of capital, and growth in jobs in Ohio.

Manufacturing is the largest contributor to the state's GDP, contributing more than 17.5 percent. The success of Ohio manufacturing – through its vast network of in-state customers and suppliers - large global firms and their local supply chains - enhances the economic vitality of all other Ohio industries and Ohioans' quality of life. Reducing tax rates in a manner that treats all taxpayers fairly should be encouraged.

Thank you very much for the opportunity to comment and provide input to this commission. Ohio's manufacturers are prepared to help improve the business climate in the state. We look forward to continuing our partnership with the administration and the General Assembly.

I'll be pleased to answer any questions you may have.

cose

council of smaller enterprises

GREATER CLEVELAND PARTNERSHIP

ADVOCACY

Ohio 2020 Tax Policy Study Commission
Written Testimony of Marty McGann, Senior Vice President of Advocacy
Greater Cleveland Partnership
January 20, 2016

Chairman Peterson and members of the Commission, my name is Marty McGann and I represent the Greater Cleveland Partnership (GCP) – Northeast Ohio's chamber of commerce. This testimony is also on behalf of the Council of Smaller Enterprises (COSE), an advocate for the small business community for more than 40 years. Together, we represent the most comprehensive small, middle market and large business partnership in the state with more than 10,000 business members in Northeast Ohio. On behalf of our members, we are grateful for this opportunity to provide testimony to the Ohio 2020 Tax Policy Study Commission.

The business owners we represent have a clear perspective on what has helped to boost the economic competitiveness of their businesses and what has not. Therefore, we believe it is important to reiterate our consistent perspectives – on behalf of Ohio's job creators – as the Commission examines and makes recommendations on current tax policy:

1) Seek greater efficiencies in state government to allow for personal income tax reductions versus shifting the tax burden from one group of businesses to another
2) Permanently preserve the 100% tax exemption on the first $250,000 in business income
3) Maintain or lower the current commercial activity tax (CAT) rate and maintain or increase the current CAT exemption level
4) Be thoughtful about the implications of expanding the sales tax base and/or increasing the rate

We are pleased that the recently passed state budget called for the creation of the 2020 Tax Policy Study Commission. It is important to have this body in place to take a thorough, static and dynamic look at Ohio's tax structure. We believe the process will ensure we are receiving a high return on investment for the dollars we spend. As the Commission and, ultimately, the legislature considers personal income tax cuts we encourage your work, but continue to believe and ask that income tax cuts be funded by government efficiencies and not by shifting higher taxes from one group to the next. The majority of our members are pass-through entities. Therefore, a reduction in personal income taxes has a direct benefit on them. We support the strongest personal income tax relief possible that will not increase the already substantial financial burden imposed on businesses.

As you know, the final version of the state budget granted a 75% tax deduction for the first $250,000 in business income for 2015 and a 100% exemption beginning in 2016. We have heard from many small business owners about the value of this policy as a resource that can produce thousands of dollars of additional capacity for re-investment. Permanently preserving the 100% exemption on the first $250,000 in business income and continued support of deductions and exemptions is absolutely critical to the support small business owners need for the investments they are making in our economy.

The CAT has been in place for more than 10 years. It is a broad gross receipts tax that generates significant amounts of revenue at low tax rates because it taxes virtually every transaction in the economic chain of bringing goods and services to market. This model was the joint commitment made among the business community, political leadership and other key stakeholders when the CAT was created in order to make the tax most effective.

However, there were concerns at that time – as there are today – about the possibility of the CAT becoming an easy target for incremental cost increases on businesses.

During the early stages of the budget process, GCP along with the Ohio Chamber of Commerce and the other metro chambers across the state commissioned a study from Ernst & Young (EY) to examine the impact of proposed changes to the CAT. The EY study showed that as the rate of the CAT increases, it becomes less marginal and begins to have a more negative impact on a number of Ohio industries – including construction and wholesaling. The estimates in the EY study were based on a single stage of production. These numbers are compounded when pyramiding occurs. Similar concerns are shared by the small business community, as an increase to the CAT and/or lowering of the exemption level would represent a tax increase on small business owners. In addition, bi-furcating the CAT rate raises concerns that a split rate will essentially amount to a tax increase on professional services and create another level of complexity in our tax code. For these reasons, we remain opposed to an increase in the CAT rate and lowering the CAT exemption level even it means maintaining the status quo in this specific area.

Lastly, expanding the sales tax base has many implications, especially when one considers the impact across Ohio where current combined local and state sales tax rates range from 6.5 to 8%. Based on financial modeling in the EY study, management services, manufacturing, healthcare, and social assistance are heavily impacted by a sales tax base expansion. These are key industries in Ohio's economy; if these estimates prove to be true, the impact may be the opposite of what we want, which is to boost the economic competitiveness of Ohio. We have significant concerns about further expansion of the sales tax to more categories of business services due to the unintended impact of the layering of these additional costs within a business' cost structure and the specific definitions that apply to certain categories in any expansion, like management consulting.

We continue to share the vision with of our state leaders to strengthen Ohio by providing for a positive economic development environment that creates opportunity for all. Small business tax relief and greater government efficiency versus shifting taxes are smart approaches to get us there. We welcome the opportunity to continue working with you to develop a comprehensive plan that will serve Ohio well. Thank you.

Ohio | Department of Taxation

Chairman McClain, Chairman Peterson, and members of the 2020 Tax Policy Study Commission, on behalf of Commissioner Joseph W. Testa and the Ohio Department of Taxation, thank you for the opportunity to provide an introduction and overview of Ohio's tax expenditures. My name is Nick Cipiti, Deputy Tax Commissioner for Tax Policy and Budget. I will be speaking to the mechanics of tax expenditures, the criteria used to determine whether a tax provision constitutes a tax expenditure, sources of data used in the estimate of tax expenditures, and the Tax Expenditure Report.

Overview-The concept of tax expenditures was first articulated in 1967 by Stanley S. Surrey, then assistant secretary for tax policy of the U.S. Department of the Treasury. The Executive and Legislative branches of the U.S. government, most state governments, and many foreign governments have since created and adopted their own versions and definitions of tax expenditures. In the broadest sense, the tax expenditure concept is uniform and constant: a tax expenditure represents a legislated variation from- more commonly a reduction to- a standardized tax base.

Ohio law defines a tax expenditure to mean a tax provision in the Ohio Revised Code (ORC) that exempts, either in whole or in part, certain persons, income, goods, services, or property from the effect of taxes established in the ORC, including, but not limited to, tax deductions, exemptions, deferrals, exclusion, allowances, credits, reimbursements, and preferential tax rates.

Tax expenditures take the form of tax benefits for certain taxpayers or activities and result in a cost to the state. Unlike direct budgetary expenditures, tax expenditures may remain in law indefinitely without a pre-determined termination date. Section 5703.48 of the Ohio Revised Code requires the tax commissioner to produce a tax expenditure report as an appendix to the biennial budget. The report gives a description of each tax expenditure as well as an estimate of revenue foregone or unavailable to the General Revenue Fund. It is available online at the OBM and ODT websites.

Criteria- The determining factor in identifying a tax provision as a tax expenditure is whether it exists as an exemption, credit, deduction, etc. in the Ohio Revised Code. The item must meet the following criteria to be considered a tax expenditure:

- The item would have been otherwise taxable had there not been a legislatively enacted exemption or exclusion.
- The item must reduce or have the potential to reduce one of the state's general revenue fund taxes.
- The item is not subject to an alternative tax.
- The item is exempt or excluded as a result of state legislative action. Anything that can only be changed by a state constitutional amendment, a federal law change, or a federal constitutional amendment is not considered a tax expenditure in this report.

The Tax Expenditure Report (TER) - The TER is produced as an appendix to the biennial budget. It provides a description of each tax expenditure and an estimate of the dollars unavailable to the GRF because of the tax expenditure for that two year period. It compares those foregone revenues to the amount of revenues that were unavailable to the GRF in the immediately preceding biennium. The report provides an estimate of the dollar value of each tax expenditure, but it makes no recommendations on the appropriateness of the expenditures.

According to the TER submitted as an appendix to a state budget issued for the biennium July 1, 1989 to June 30, 1991, estimated tax expenditures represented 64.8% of projected general fund revenues for taxes for which tax expenditures existed in the 1988-1989 biennium or about 11 billion dollars of the approximately 17.1 billion dollars of projected general fund revenues for that biennium from those taxes. For the current biennium, estimated tax expenditures are projected to be approximately 17.35 billion dollars or 36.8% of the projected bluebook revenues of about 47.2 billion dollars from the taxes for which there are tax expenditures. Estimates were developed for 128 tax expenditures.

It is important to note that while these nominal dollar figures help provide some quantification of overall tax expenditures relative to general fund revenues from those taxes, each tax expenditure is estimated assuming all other expenditures remain in law. Because there may be unaccounted for overlap between expenditures, these figures are not intended to be relied upon as an estimate of the revenue gain if all tax expenditures were repealed simultaneously.

Data Sources-The Department estimates each expenditure statically using the most reliable data available. Any estimate's accuracy depends upon the reliability of the data. Generally speaking, the Department considers internal data to be more reliable than external data; however, internal data is not always available for the estimation of certain tax expenditures. Accordingly, the department devised data reference codes for individual expenditures:

- Data Source Code A is internal departmental data,
- Data Source code B is data produced by governmental agencies other that the department, and

- Data Source Code C is all other data including data from business information service providers, academic research, and non-profit organizations. Some estimates may be based on a mixture of data sources.

For the most recent TER, 44 or 34.4% relied on data source code A, 28 or 21.9% were a mixture of A and another code, 25 or 19.5% were B, 14 or 10.9% were B and another code, and 17 or 13.3% were C. Of the major taxes, the tax with the most "A" estimates is the personal income tax (56%), and the tax with the least "A" estimates is the Sales and Use Tax (14%). Thus, one point worth consideration with tax expenditure legislation is data reporting. I believe that the more taxpayers are required to report "A" source code data quantifying the tax benefit, the higher the confidence will be in the reliability of the estimates.

Co-Chairmen and members of the Commission, I hope this concise discussion of the Department of Taxation's TER is of value to you. On behalf of the Tax Commissioner, I again would like to thank you for the invitation to discuss this important subject of tax policy. I would be happy to take your questions.

Testimony Submitted to the Ohio 2020 Tax Policy Study Commission

February 24, 2016

Greg R. Lawson, Statehouse Liaison
The Buckeye Institute for Public Policy Solutions

Thank you Co-Chairs Peterson and McClain, and members of the Ohio 2020 Tax Policy Study Commission for the opportunity to discuss tax expenditures with you today. My name is Greg R. Lawson. I am the Statehouse Liaison and a policy analyst at The Buckeye Institute for Public Policy Solutions, a free-market think tank that believes low taxes and limited government regulations will lead to a more prosperous Ohio.

To foster that low-tax, limited-government environment, The Buckeye Institute has long championed a lower, flatter, simpler tax structure with fewer distortions, exemptions, and carve-outs. We believe that such a structure will prove more efficient, fairer for taxpayers, and ultimately spur greater economic growth throughout the state. We commend the General Assembly and Governor Kasich for the tax reform steps that they have already taken, and we recognize that many of the next steps may be even more difficult. Tax expenditures, unfortunately, only exacerbate what is likely to be an already arduous reform process.

Every tax expenditure is really just an exception to the tax code that narrows the tax base. The narrower the tax base the higher and more confiscatory taxes become for those still subject to the tax. Thus, tax expenditures, however unintentionally, eventually pick "winners" and "losers" through their preferential tax treatment. Flatter taxes, by contrast, levied on broader bases and without special exemptions, lower the tax burden and spread the cost more evenly among the taxpayers.

Unfortunately, tax expenditures at the state level abound. The Tax Commissioner's report details at least 128 tax expenditures,[1] many of which were initially created for good reason. But once these tax expenditures are ensconced in statute they grow immune to scrutiny and subject to ferocious lobbying to retain them—some have been on the books since the days of the horse and buggy. Practically by definition, some constituency set to gain from the tax preference calls for the creation of each tax expenditure. Once created, of course, that constituency has every financial incentive to protect their favorable tax treatment, making it politically difficult to ever eliminate the tax expenditure. The vicious cycle is perpetuated as others look for their own special treatment, making the tax base narrower and narrower as the government continues to pick its tax "winners" and "losers."

Despite a cursory review during the initial budget blue print drafting every two years, there are few, if any, state-level performance audits that review tax expenditures for efficiency, effectiveness, or fairness. In 2011, The Buckeye Institute joined with others across the ideological spectrum to outline a performance audit process for tax expenditures and call for an automatic sunset provision for those that do not garner an affirmative vote by the General Assembly to retain them. At that time, The Buckeye Institute, the Center for Community Solutions, and the Greater Ohio Policy Center proposed the following commonsense reforms:

- Define tax expenditures consistent with current Executive Budget estimates;
- Limit the duration of tax expenditures to 8 years unless re-enacted by General Assembly;
- Establish a schedule of sunset dates for current tax expenditures;

[1] Joe Testa, "Tax Expenditure Report for Fiscal Years 2016-2017," Ohio Department of Taxation, January 27, 2015, http://obm.ohio.gov/Budget/operating/doc/fy-16-17/State_of_Ohio_Budget_Tax_Expenditure_Report_FY-16-17.pdf.

- Provide for a Joint Tax Expenditure Review Committee comprised of the Chairs and Ranking Minority Members of the Ways and Means and Finance Committees of the House and Senate, plus two members appointed from each chamber;
- Provide for the Joint Committee's periodic cost-benefit analysis of all tax expenditures.

We still stand by these reforms today, and continue to call for a more active review process for tax expenditures. We appreciate that current beneficiaries of individual tax expenditures will likely oppose such reforms, but we think that the legislature should have a routine process for examining, revising, and even eliminating tax expenditures.

House Bill 9, sponsored by Representative Boose, contains many of these proposed reforms, but it does not include the crucial sunset provision that will help ensure that all tax expenditures are reviewed and reconsidered. We think that such a provision will help reduce the risk of an ad hoc review and provide a more systematic and thorough process—away from the fever pitch of biennial budget drafting. We also think that these reforms may help eliminate some of the more notorious tax expenditures such as the "NetJets" exemption and the political contribution income tax credit, and allow the General Assembly to better understand the full effect of *all* tax expenditures on state revenues.

There is at least one massive tax expenditure, for example, that the General Assembly may not even realize is tax expenditure because the Ohio Department of Taxation does not count it among the state's tax expenditures—the carryout food tax exemption. As the Commission knows, carryout food is exempt from state sales taxes. But because this exemption lies in the state Constitution and it cannot be changed by statute, it does not meet the technical definition of tax expenditure. If it walks like a duck and talks like a duck, chances are it's a duck. Any tax exemption, exclusion, or credit, of course, is at bottom a tax expenditure,[2] but an arbitrary distinction keeps the carryout food sales tax exemption out of the Tax Commissioner's tax expenditure report—which means that the General Assembly is unlikely to appreciate its full cost during the biennial budget process. Consequently, The Buckeye Institute recommends including the amount of the carryout exemption in all future TE reports issued during the budget process.

Although a tax exemption for groceries, for instance, combats concerns over regressive taxation, there is no similar concern over "eating in" vs. "eating out" at restaurants. The carryout exemption ultimately gives some restaurants a tax break advantage over others—once again government tax policy picking its winners and losers. Most other states do not give their carryout establishments such a leg-up on the competition. Only Georgia, New Jersey, and Vermont exempt carryout from sales tax, with Illinois having a 1% discount. Ohio should abandon this out-of-step minority.

The carryout food exemption probably costs Ohio hundreds of millions of dollars in tax revenues every year that could be used to further broaden, flatten, and even-out the tax base. The Tax Commissioner's most recent tax expenditure report shows Ohio will forego nearly $8.9 billion in revenue in Fiscal Year 2017.[3] Adding the carryout exemption would likely

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[2] Joint Committee on Taxation, "Publications on Tax Expenditures," U.S. Congress, accessed on February 17, 2016, https://www.jct.gov/publications.html?func=select&id=5.
[3] Joe Testa, "Tax Expenditure Report for Fiscal Years 2016-2017," Ohio Department of Taxation, January 27, 2015, http://obm.ohio.gov/Budget/operating/doc/fy-16-17/State_of_Ohio_Budget_Tax_Expenditure_Report_FY-16-17.pdf.

push that total closer to $10 billion lost to tax expenditures. Certainly some of those revenues could be used to create a far more competitive tax environment for the entire state.

Although some with vested interests in tax expenditures will likely resist necessary reforms like those we have advocated, it is worth noting that special tax treatment has a very real impact on local communities and businesses. Local jurisdictions, not just the state, should embrace the concept of performance audits and statutory sunsets of their tax expenditures. We often hear about "winning" the battle with Indiana, or Kentucky, or that State Up North for securing the location of a particular company's new expansion. The city or local community that "wins" that battle stands to benefit most from the new expansion. By limiting tax expenditures and working to make Ohio's overall tax burden lower, flatter, and fairer, the state becomes more attractive and more business-friendly for companies looking to expand or relocate.

Ohio has shown marked improvement in the race for a lower tax burden. The non-partisan Tax Foundation's state/local tax burden rankings show that Ohio improved from 7th highest in 2005 to 19th highest in Fiscal Year 2012.[4] The Ohio Department of Taxation reports that in 2012-2013 the state's tax burden still ranked 33rd as measured per capita, and 32nd measured as a percentage of income.[5] The same analysis finds that Ohio ranks 18th in per capita local tax burden, and 9th as a percentage of income.[6] Ohio should look for ways to continue improving the state's overall tax burden rankings, not perpetuate tax policies like

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[4] Tax Foundation, "Annual State-Local Tax Burden Ranking FY12," Tax Foundation, January 20, 2016, http://taxfoundation.org/article/state-local-tax-burden-rankings-fy-2012.
[5] Ohio Department of Taxation, "State and Local Tax Comparisons, 2012-2013," December 17, 2015, http://www.tax.ohio.gov/Portals/0/tax_analysis/tax_data_series/state_and_local_tax_comparison/tc12/TC12CY13.pdf.
[6] *Ibid.*

tax expenditures that create perverse incentives for Ohio's local jurisdictions and businesses to compete with each other in ways that fail to grow the economic and jobs pie. In the long run, no local community's economic pie will grow by offering favorable tax incentives to one business but not the other across the street. That's not economic development, that's cannibalism.

To conclude, Ohio policymakers should look to further flatten and lower the state's overall tax burden, and eliminating tax expenditures is yet another means toward that end. Ultimately, some, maybe even most tax expenditures will survive, but they should only remain on the books after an affirmative vote by the General Assembly and a true performance audit that provides a complete picture of all tax expenditures—the carryout food exemption included.

I have attached to my testimony a list of the tax expenditures that should receive greater scrutiny—whether through an audit process or during the next biennial budget process—and I would be happy to answer any questions that the Commission might have at this time.

PROPOSED TAX EXPENDITURE REPEAL

Tax Expenditure	**Estimated Foregone Revenue in FY 2016**	**Estimated Foregone Revenue in 2017**	**Rationale for Elimination**
Exemptions Based on Specified Use of Property or Service			
Qualified Tangible Personal Property Used in Making Retail Sales	$45,900,000	$47,900,000	Items such as the purchasing of catalogs consumed in retail sales can be considered a legitimate "cost of doing business" as are purchases of items subsequently used by direct marketing vendors for the production of printed advertising materials. It is questionable that in an Internet era where "print items" are already becoming antiquated, that such a specialized exemption remains necessary.
Copyrighted Motion Picture and Films	$9,300,000	$9,500,000	Given that rentals for private home use are not exempt from taxation, there appears to be a double-standard when it pertains to rentals for "exhibition" purposes
Tangible Personal Property Used In Electronic Publishing	$6,400,000	$6,500,000	This is a relatively new exemption from 2007. It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.
Sales and Use Tax Exemption			
Newspapers	$22,500,000	$22,500,000	Magazines and other

			subscription based publications are not exempted.
$800 Tax Cap on Qualified Fractionally-Owned Aircraft	Under $1 million	Under $1 million	While recognizing the mobility of those in the market for fractionally owned aircraft, it is questionable why there is such a low cap for sales tax on an item geared to those of higher affluence.
Sales of Materials and Services for Maintenance and Repair of Aircraft	$4,100,000	$4,100,000	This is a relatively new exemption from 2008. It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.
Flight Simulators	$3,100,000	$3,100,000	This is a relatively new exemption from 2008. It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.
Agricultural Land Tile and Portable Grain Bins	$1,400,000	$1,400,000	It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.
Purchases of Qualified Tangible Personal Property to Qualified Motor Racing Teams	Under $1 million	Under $1 million	It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.

PROPOSED TAX EXPENDITURE REPEAL

Sales of Tangible Personal Property and Services for Maintenance and Repair of Qualified Fractionally-Owned Aircraft	Under $1 million	Under $1 million	This exemption corresponds with the above exemptions related to aircraft.
Items used to Storing, Preparing, and Serving Food in a food service operation	$32,200,000	33,200,000	Applies to establishments that prepare and serve food in individual portions; sales tax can be absorbed as part of the normal costs of business. Sales to charitable organizations would remain exempt
Tangible Personal Property Used in Preparing Eggs for Sale	$2,900,000	$3,000,000	It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.
Income Tax Deductions			
$50 Credit for Taxpayers Aged 65 Years or Older	$29,600,000	$31,000,000	Given increasing lifespans, it is questionable that a credit for no other reason than age can achieve a broad public purpose outside of political considerations. Further, all savings are expected to be put into across the board income tax rate reductions.
$20 Personal Credit for those with less than $30,000 in income	$67,100,000	$67,200,000	Income tax rates have been lowered substantially and should continue to be lowered. This credit is no longer needed.
Campaign Contributions Credit	$3,800,000	$4,200,000	Outside of political considerations, there appear no other public policy impacts for this exemption.

PROPOSED TAX EXPENDITURE REPEAL

Deduction for College Savings Account Contributions	$10,200,000	$10,400,000	Taxpayers will take advantage of tax-free savings without a deduction.
Grape Production Credit	Under $1 million	Under $1 million	It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.
Motion Picture Tax Credit	$19,300,000	$19,300,000	These credits only create temporary jobs and do not create a sustainable economic base. They also privilege some film makers over others.
Ethanol Plant Investment Credit	Under $1 million	Under $1 million	It appears as a narrowly tailored carve-out with limited applicability and impact outside of a highly specialized group.
CAT Tax			
Net Operating Loss Credit	$6,800,000	$7,100,000	NOL carry-forward is tax concept from the former corporate franchise tax transferred to the CAT, which is a gross receipts concept; Available only to large companies
Grand Total	**$264,600,000**	**$269,400,000**	

TESTIMONY REGARDING THE OHIO DEPARTMENT OF TAXATION'S TAX EXPENDITURE REPORT FOR FISCAL YEARS 2016-2017

Before the 2020 Tax Policy Study Commission

David A. Froling
Tax Counsel for the Ohio Council of Retail Merchants

February 24, 2016

Good morning, Chairmen Peterson and McClain and members of the Commission. My name is Dave Froling. I am a state and local tax partner with the law firm Vorys, Sater, Seymour and Pease LLP. I am testifying today on behalf of the Ohio Council of Retail Merchants. The Council appreciates the opportunity to address the Commission regarding the Ohio Department of Taxation's Tax Expenditure Report for Fiscal Years 2016-2017.

At the outset, it is important for the Commission to understand how important retailers are to Ohio and the State's fisc. As to Ohio, the retail industry accounts for $46.5 billion of Ohio's annual Gross Domestic Product and the retail industry supports 1.5 million jobs, which is one in four of all Ohio jobs - - more than any other industry. As to the State's fisc, simply put, the more taxable sales retailers make, the more Ohio sales tax retailers collect and remit to Ohio. Previous General Assemblies recognized this truism and have passed legislation to maximize the collective interests of retailers and the State. As Ohio embraces consumption based taxes over income taxes, legislative policy relative to maximizing retail sales becomes increasingly more important to both retailers and the State. In this regard, the General Assembly should consider enhancing several of the expenditures that I will discuss shortly.

The public policies - - often referred to as "tax expenditures" - - that I will highlight today are of great benefit to retailers. That said, some of these expenditures benefit the retail industry more than other expenditures, and to be sure, some expenditures benefit multiple industries.

1. Section 1.05: Packaging and packaging equipment.

    a. Sales and Use tax

    b. FY 2017 Revenue Forecast: $328,900,000

    c. R.C. 5739.02(B)(15); originally enacted 1961.

    d. This exemption exempts packaging and packaging equipment, including materials, labels, and parts for packaging machinery and equipment sold to manufacturers and other qualified businesses. There has been much litigation over this exemption.

    e. Examples: shopping bags and gift boxes.

    f. The utility of packaging and packaging equipment is of utmost importance to retailers and consumers. This exemption minimizes the costs of selling merchandise, thereby providing greater purchasing power to consumers.

2. Section 1.10: Tangible Personal Property used in storing, preparing and serving food.

    a. Sales and Use tax

    b. FY 2017 Revenue Forecast: $33,200,000

    c. R.C. 5739.02(B)(27); originally enacted 1981.

    d. This exemption exempts tangible personal property used in storing, preparing and serving food in a commercial food establishment, as well as property used to clean, store, prepare or serve food for human consumption.

    e. Examples: Generally any property that you would find or use in a kitchen.

    f. This exemption is vital to retailers engaged in providing food products to the general public. The exemption helps maximize sales, protect the public health, and preserve inventory in a safe manner.

3. Section 1.14: Property used to fulfill a warranty or service contract.

    a. Sales and Use tax

    b. FY 2017 Revenue Forecast: $50,900,000

    c. R.C. 5739.02(B)(42)(k); originally enacted 1986.

d. This exemption exempts parts and labor used to fulfill a warranty, maintenance, or service contract that is provided as part of the price of tangible personal property sold. Such contracts are subject to Ohio sales tax on the front end, so Ohio does not require sales tax to be charged on the back end.

e. Examples: Warranties are frequently offered by retailers when selling electronic items, computers and appliances.

4. Section 1.16: Tangible Personal Property used in research and development.

   a. Sales and Use tax

   b. FY 2017 Revenue Forecast: $30,200,000

   c. R.C. 5739.02(B)(42)(i); originally enacted 1993.

   d. This exemption exempts tangible personal property used in research and development. Qualified research and development equipment is defined at R.C. 5739.014(HH) and is limited to capitalized property and leased property that would be capitalized if purchased.

   e. Examples: There are many examples. Ohio is the home state of several world-wide restaurants retailers. These retailers have test kitchens in their home office to develop new menu items.

   f. Many retailers must continually upgrade and improve their merchandise as well as offer new and innovative products to their consumers. This exemption minimizes the internal costs associated with developing new and/or improved products. This exemption should be expanded to include purchases that are expensed.

5. Section 1.18: Qualified Tangible Personal Property used in making retail sales.

   a. Sales and Use tax

   b. FY 2017 Revenue Forecast: $47,900,000

   c. R.C. 5739.02(B)(35); originally enacted 1935.

   d. This exemption exempts advertising material or catalogs used or consumed in making retail sales that price and describe property offered for retail sale.

   e. The importance of advertising to the retail industry is obvious. We anticipate Ohio would lose at least this much sales tax revenue by repealing this exemption. In fact, the General Assembly should consider making this exemption more robust by removing the price and describe requirement.

6. Section 1.19: Property used in highway transportation for hire.

    a. Sales and Use tax

    b. FY 2017 Revenue Forecast: $47,800,000

    c. R.C. 5739.02(B)(32); originally enacted 1985.

    d. This exemption exempts the sale, lease, repair and maintenance of motor vehicles primarily used in transporting personal property by a person engaged in highway transportation for hire.

    e. This exemption provides incentive to retailers to be vertically integrated, thereby reducing their external costs of transporting their merchandise to their stores.

7. Section 1.20: Qualified call center exemption.

    a. Sales and Use tax

    b. FY 2017 Revenue Forecast: $40,100,000

    c. R.C. 5739.02(B)(45); originally enacted 2003.

    d. This exemption exempts the sale of telecommunication services that are used directly and primarily to perform the functions of a qualified call center. A call center is any physical location where telephone calls are placed or received in high volume for the purpose of making retail sales, marketing, customer service, technical support, or other specialized business activity, and that employs at least 50 individuals that engage in call center activities on a full-time basis.

    e. This exemption provides an incentive to retailers to locate their call centers in Ohio and not outsource their call centers overseas. This exemption indirectly encourages retailers to locate their headquarters in Ohio as well. This exemption helps foster job creation, particularly in central Ohio.

8. Section 1.22: Equipment used in distribution warehouses.

    a. Sales and Use tax

    b. FY 2017 Revenue Forecast: $3,600,000

    c. R.C. 5739.02(B)(42)(j) and (B)(48); originally enacted 1994.

    d. This exemption exempts equipment used primarily in handling purchased sales inventory in a distribution facility when the inventory is primarily distributed outside Ohio to (i) the retail stores of the person (or an affiliated entity) who owns or controls the distribution facility; or (ii) customers if the facility is owned by a mail order business; or (iii) independent salespersons operating as direct sellers if the facility is owned by a qualifying direct selling entity.

e. This exemption provides an incentive to retailers to locate their distribution centers in Ohio. This exemption indirectly encourages retailers to locate their headquarters in Ohio as well. This exemption helps foster job creation throughout Ohio.

9. <u>Section 1.34: Discount for vendors</u>

a. Sales and Use tax

b. FY 2017 Revenue Forecast: $71,000,000

c. R.C. 5739.12 and 5741.12; originally enacted 1981.

As you know, Ohio's retailers are required by law to collect sales tax on all retail sales made in Ohio, and to timely remit that tax to the State. This collection and remittance obligation extends not only to the general revenue fund component of the tax, which is currently set at a rate of 5.75%, but also with respect to the local county piggyback taxes that range anywhere from 0.25% to 2.25% throughout the State. To help defray the costs associated with these collection and remittance obligations, Ohio law has allowed retailers that remit on a timely basis to retain a portion of the collected tax, ranging anywhere from 0.5% to 1.5% over the past thirty years or so. This retention is commonly referred to as the "vendor discount."

The term "vendor discount" is a misnomer. The more accurate term should be "vendor compensation" as this amount represents the fee that Ohio pays retailers for serving as a trustee of the State for collecting and timely remitting the State's sales tax. Indeed, the Council questions why the vendor discount is listed as a tax expenditure. The vendor discount is not "lost" revenue. The vendor discount should be described more accurately as an investment in a partnership between public and private sectors that support the efficient collection and remission of billions of dollars in sales tax. Applying the Expenditure Report's questionable logic to its extreme, the state should report as a "tax expenditure" all expenses that the State paid to "outside" contractors for the various services that the State buys each year.

Under current law, the discount is three-fourths of one percent (i.e., 0.75% or .0075) of the sales tax collected by retailers. See, R.C. 5739.12(B). The discount is not capped. Id. The Department of Taxation estimates the vendor discount equates to roughly $71 million of foregone tax revenue for fiscal year 2017.

The purpose of the discount is to reimburse vendors for the vendor's compliance costs associated with collecting and remitting the sales tax. A 2006 study prepared by PricewaterhouseCoopers LLP, styled "*Retail Sales Tax Compliance Costs: A National Estimate*," indicates that, during 2003, average state and local sales tax compliance costs for all retailers in the U.S. were 3.09% of sales taxes collected. When broken down by size, small retailers were at 13.47%, medium retailers were at 5.20% and large retailers were at 2.17% of sales taxes collected. The Council has no reason to believe these percentages have changed materially since 2003. That said, Ohio's current discount of 0.75%, is less than one-fourth of the national average.

To be sure, any notion that the costs to vendors for sales tax collection and remittance are minimal is completely false. Such a notion does not comport with reality. As noted in the PwC study, the following cost categories, among others, are those encountered by vendors in connection with sales tax collection and remittance obligations:

(i) Hiring and training personnel on sales tax;

(ii) Purchasing and maintaining software necessary for sales tax compliance;

(iii) Purchasing and maintaining equipment necessary for sales tax compliance (*e.g.*, cash registers);

(iv) Preparation of returns and related documents;

(v) Documenting and confirming tax-exempt sales;

(vi) Addressing and defending sales tax audits and assessments;

(vii) Providing customer service associated with sales tax issues;

(viii) Losses associated with unrecovered sales tax paid due to bad debt;

(ix) Bank charges on EFT sales tax payments; and

(x) Credit card fees on sales tax collections.

To assert that the foregoing cost categories are inconsequential is without merit. For example, a 1.55% credit or debit card fee imposed on the sales tax that a vendor is required to collect adds a material cost that the vendor incurs solely because of its tax collection responsibilities. At a tax rate of 7.5% on a $100 transaction, for example, the added cost is 11.6 cents, or approximately 1.55% of the tax collected on that transaction. The Council commissioned the University of Cincinnati's Economic Center to study the economic impact of the vendor discount to retailers. Attached at Exhibit B is the University's report for your review and consideration. Note retailers make 60% of their sales to consumers who use a credit or debit card.

The credit card fees are material to retailers. An 11.6 cent fee to collect $7.50 of sales tax is significant when considering the thousands of sales that retailers make to consumers each year. The Commission must understand that the State of Ohio is well aware of how material these costs are as the State passes along these costs to taxpayers who wish to pay their taxes via credit or debit card. In this regard, the state charges 2.5% or $1.00, whichever is greater, to any taxpayer wishing to pay tax via credit or debit card. The Commission must also understand that retailers, by contract, cannot pass along these fees the way the State can.

While advancements in technology may have increased the efficiency of the collection and remittance process, such advancements have not eliminated all of the associated costs. The technology does not come free of charge nor is it capable of operation without human guidance, oversight and maintenance.

10. Section 1.45: Tangible Personal Property for use in a retail business outside Ohio.

    a. Sales and Use tax

    b. FY 2017 Revenue Forecast: Below $1,000,000

    c. R.C. 5739.02(B)(21); originally enacted 1968.

    d. This exemption exempts sales of tangible personal property manufactured in Ohio, if sold by the manufacturer in Ohio to a retailer for use in the retail business of the retailer outside Ohio.

    e. This exemption provides an incentive to retailers to utilize Ohio-based manufacturers.

11. Section 4.03: State and federal cigarette excise taxes.

    a. Commercial Activity Tax

    b. FY 2017 Revenue Forecast: $3,500,000

    c. R.C. 5751.01(F)(2)(q); originally enacted 2005.

    d. This exemption exempts an amount equal to federal and state excise taxes paid for cigarette or other tobacco products.

    e. The CAT is a privilege tax for the privilege of engaging in business in Ohio. The tax is measured by the taxpayer's gross receipts sourced to Ohio. The tax is designed to tax "commercial activity" in Ohio. A taxpayer that collects excise taxes on behalf of the U.S. and Ohio should not have to pay CAT on the amount collected. To not provide this exemption effectively raises the CAT rate on any taxpayer engaged in selling these types of products.

12. Section 4.05: State and federal alcoholic beverage taxes

    a. Commercial Activity Tax

    b. FY 2017 Revenue Forecast: $1,100,000

    c. R.C. 5751.01(F)(2)(s); originally enacted 2005.

    d. This exemption exempts an amount equal to federal and state excise taxes paid for beer or intoxicating liquor.

e. Again, the CAT is a privilege tax for the privilege of engaging in business in Ohio. The tax is measured by the taxpayer's gross receipts sourced to Ohio. The tax is designed to tax "commercial activity" in Ohio. A taxpayer that collects excise taxes on behalf of the U.S. and Ohio should not have to pay CAT on the amount collected. To not provide this exemption effectively raises the CAT rate on any taxpayer engaged in selling these types of products.

Members of the Commission, this concludes my prepared remarks. I appreciate your attention and I thank you for your time. I would be happy to answer any questions you may have.

Exhibit A

Section	Description	Tax Type	FY 2017 Estimated Revenue
1.05	Packaging and packaging equipment	Sales/Use Tax	328.9
1.10	Tangible Personal Property used in storing, preparing and serving food	Sales/Use Tax	33.2
1.14	Property used to fulfill a warranty or service contract	Sales/Use Tax	50.9
1.16	Tangible Personal Property used in research and development	Sales/Use Tax	30.2
1.18	Qualified Tangible Personal Property used in making retail sales	Sales/Use Tax	47.9
1.19	Property used in highway transportation for hire	Sales/Use Tax	47.8
1.20	Qualified call center exemption	Sales/Use Tax	40.1
1.22	Equipment used in distribution warehouses	Sales/Use Tax	3.6
1.34	Discount for vendors	Sales Tax	71.0
1.45	Tangible Personal Property for use in a retail business outside Ohio	Sales/Use Tax	Minimal
4.03	State and federal cigarette excise taxes	CAT	3.5
4.05	State and federal alcoholic beverage taxes	CAT	1.1

Economics Center

Analysis of Proposed Changes to the Vendor Discount in Ohio's Executive Budget

Prepared for

Focus on Ohio's Future

by the

University of Cincinnati Economics Center

March 18, 2015

University of Cincinnati

Introduction

This report investigates the economic impact of the proposed change to the vendor discount in the Executive Budget legislation, House Bill 64. The proposal limits the reimbursement amount that retail merchants, acting as agents of the state, can receive for timely remittance of the sales tax. In particular, the proposed budget "blueprint" states:[1]

"Ohio allows retail stores, restaurants and other sales tax vendors to keep 0.75 percent of all the sales tax they collect—with no limit—to cover expenses associated with reporting and paying this tax. Prior to computerization this was justified, but today it is not. ***Ohio will now limit the discount to $1,000 a month****, meaning smaller businesses will keep the full discount, while big volume retailers — those doing about $2 million or more in taxable sales a month — will no longer be disproportionately paid for their effort to report and remit sales taxes to the state."*

Findings

Many of the figures in this report are sourced from the 2006 paper, "Retail Sales Tax Compliance Costs: A National Estimate" prepared for the Joint Cost of Collection (JCC) Study.[2] This public-private partnership included the Council on State Taxation, Federation of Tax Administrators, National Conference of State Legislatures, National Retail Federation, and several other national retailers. The analysis of nearly 800 responses from retailers across the country was conducted by the National Opinion Research Center at the University of Chicago and the Office of Tax Policy Research at the University of Michigan. The researchers identified compliance costs under two categories: variable costs and fixed costs. Fixed costs do not increase at the same rate as the amount of sales tax collections, while variable costs are directly proportional to the volume of retail sales. Variable costs include:

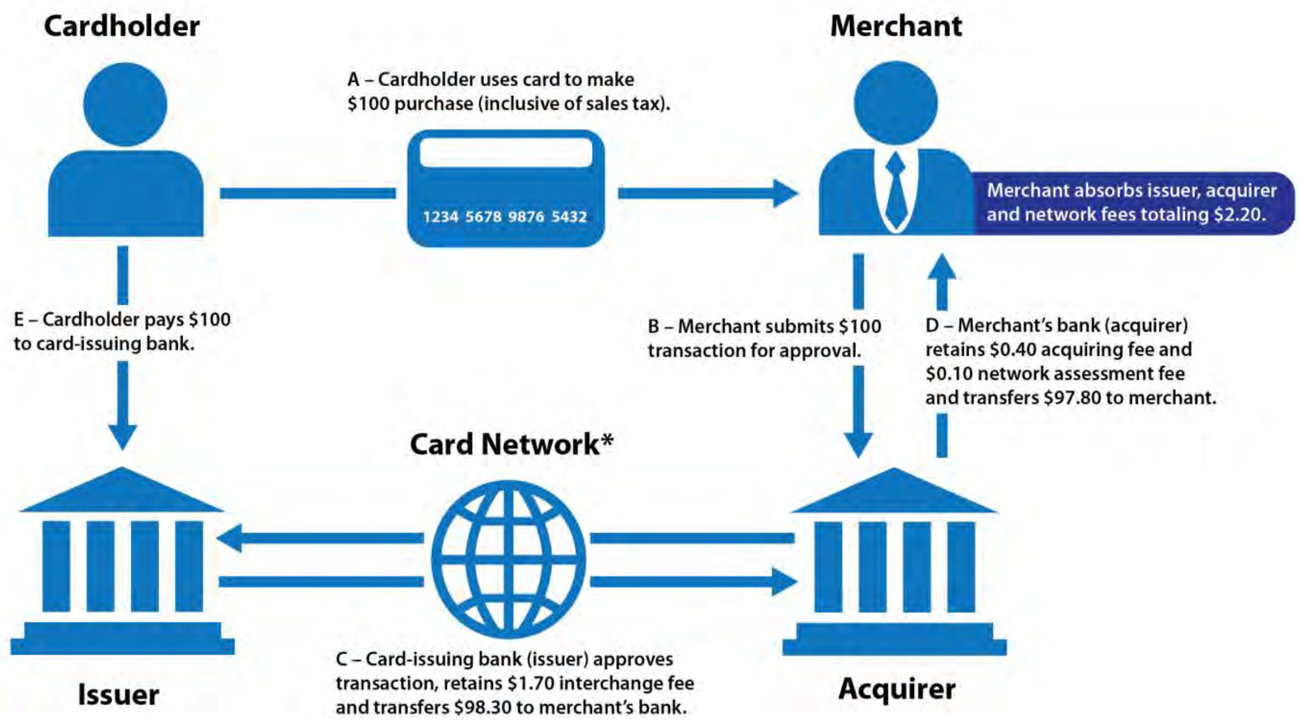
- Interchange fees
- Unrecovered sales tax paid due to bad debts

[1] http://www.blueprint.ohio.gov/Tax.aspx

[2] http://netchoice.org/wp-content/uploads/cost-of-collection-study-sstp.pdf

Interchange fees are assessed to a merchant each time a consumer makes a purchase using a credit or debit card. Figure 1 illustrates the interchange fee process with a $100 purchase that *includes sales tax*:

Figure 1[3]



Note: Fees in this example are typical but not average. Dollar amounts, except network assessment fee, are from a similar flow chart in "Rising Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges," a Government Accountability Office report from November 2009.

* The card network assesses additional fees on the issuer and merchant.

These interchange fees are assessed on the total purchase amount, including sales tax. Interchange fees can vary widely depending on the type of card, merchant category, merchant size, and processing mode (e.g. Internet sales vs. in-person signature).[4] The figure below from a 2009 US Government Accountability Office report shows the variation in interchange fees, along with the increase over time.

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[3] https://www.richmondfed.org/publications/research/economic_brief/2011/pdf/eb_11-05.pdf

[4] http://www.gao.gov/assets/300/298664.pdf

Figure 2

Changes in rates from 1991 and 2009	Visa	MasterCard
Number of interchange rate categories in 1991	4	4
Number of interchange rate categories in 2009	60	243
Range of interchange rates in 1991	1.25% to 1.91%	1.30% to 2.08%
Range of interchange rates in 2009	0.95% to 2.95%	0.90% to 3.25%
Percentage of rates that increased	43%	45%
Percentage of rates that stayed the same	45%	45%
Percentage of rates that decreased	12%	10%

Source: GAO analysis of Visa and MasterCard interchange fees schedules.

Note: Any additional transaction fees or rates that were not based on a percentage of the total sales amount were excluded from this analysis. For example, Visa has a flat fee of 75 cents for payments accepted by utility companies. Analysis of increases or decreases in rates compared each rate when initially introduced with its level as of April 2009.

However, not every retail transaction involves interchange fees. The table below from the Federal Reserve Bank of San Francisco's report *Evidence from the Diary of Consumer Payment Choice*[5] shows that only 60 percent of transactions involve credit or debit cards. As a result, the average interchange fee on a credit or debit card purchase is 1.55%. This rate means that the retailer's costs as a sales tax collection agent increase proportionally with the volume of sales. A large retail merchant does not enjoy any economies of scale under interchange fees.

Table 1: Interchange Fee Calculation

	Cash	Check	Credit	Debit	Electronic	Other	Total
Food and Personal Care Supplies	$200.20	$26.50	$153.60	$217.50	$0.00	$27.50	$625.30
General Merchandise	$48.40	$50.80	$142.00	$108.10	$53.50	$7.40	$410.20
Retail Spending	$248.60	$77.30	$295.60	$325.60	$53.50	$34.90	$1,035.50
Payment Type Percentage	*24%*	*7%*	***29%***	***31%***	*5%*	*3%*	*100.00%*
Interchange Fee			2.00%	1.14%			**1.55%**

[5] http://www.frbsf.org/cash/files/FedNotes_Evidence_from_DCPC.pdf

Unlike the state of Ohio that assesses a 2.5% surcharge (or $1.00, whichever is greater) on consumers who make payments using credit or debit cards in order to cover the cost of interchange fees, card issuers contractually prohibit retailers from passing their interchange costs on to consumers.

In addition, the JCC study reports that the estimate of lost revenue from bad debt is roughly half of the loss from interchange fees for retailers with over $10 million in annual sales.[6] This loss estimate is not constrained by the size of the retailer. With bad debt, a retailer will absorb costs based on a fixed percentage of sales volume.

However, there are certain sales tax compliance costs which are considered fixed. These fixed costs include[7]:

- Training of personnel on sales tax
- Documenting tax-exempt sales
- Customer service relating to sales tax issues
- Sales tax-related software and license fees
- Programming and servicing cash registers
- Returns preparation and related costs (remittances, refund credits, and sales tax research)
- Dealing with sales tax audits and appeals
- Other compliance costs

Larger retailers do benefit from economies of scale with these costs. For example, the costs associated with identifying if a particular item for sale is tax-exempt is constant whether or not a retailer sells one item or ten thousand items. It is not entirely accurate to say that these costs are fixed, because larger retailers are likely to have an increased variety of items for sale (thus, increasing the associated costs). However, for purposes of this report, these costs can be considered fixed. Like interchange fees, these costs can vary widely; however, the Economics Center used the figure provided in the JCC study for large retailers with over $10 million in annual sales. The study estimates that these fixed costs are equal to the costs associated with interchange fees and bad debt.

[6] For example, in Ohio, a merchant cannot receive a refund of sales tax for bad debt associated with a private label credit card that is managed by a third-party lender.

[7] Page E-3 of JCC Study

Combining the variable and fixed costs associated with sales tax compliance generates the following estimate for the annual level of sales at which a retailer is worse-off under the proposed vendor discount cap. Based on calculations in Table 2, the Economics Center finds that the monthly break-even volume of sales is approximately $574 thousand, considerably less than the Executive Budget's estimate of $2 million. Any company with more than **$6.9 million** in annual sales is worse-off under the proposal. According to the most recent business count estimates from Hoovers, Ohio has more than **900 companies** in Retail Trade[8] that generate this level of retail activity.

Table 2: Break-even Calculation Estimate

Total Annual Taxable Sales	**$6,886,233**
Total Monthly Taxable Sales	**$573,853**
Ohio State Sales Tax Rate	6.25%
State Sales Tax Collections	$35,866
Credit + Debit Card Percentage	60%
Amount Subject to Interchange Fees	$21,516
Interchange Fee Percentage	1.55%
Interchange Fees	$334
Bad Debt Percentage	0.77%
Bad Debt on Sales Tax	$166
Fixed Costs of Compliance	$500
Total Monthly Average Cost to Retailers	**$1,000**

[8] NAICS Codes 44-45

Conclusion

Currently, Ohio allows retail stores to keep 0.75 percent of all the sales tax they collect to cover expenses associated with reporting and paying this tax. However, if House Bill 64 is passed as introduced, the vendor discount will be limited to $1,000 a month. When the actual costs of tax collection exceed $1,000, retailers will be required to absorb these costs. As a result, there are potentially over 900 larger-sized retailers that will be made worse-off under this proposed legislation. The most successful retailers will suffer the most because interchange fees and bad debt are dependent on the total volume of sales. These variable charges represent half of the compliance costs for sales tax collection. Permitting all retailers, regardless of sales volume, to recoup some of the costs associated with sales tax compliance in a manner that is equally proportionate to the amount of tax collected maintains a level playing field.

Project Staff

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About the Economics Center:

The Research and Consulting division of the Economics Center provides the knowledge building blocks that help clients make better policy and economic development decisions. Our dynamic approach and critical data analysis empower leaders to respond to changing economic conditions, strengthen local economies and improve the quality of life for their communities.

BEFORE THE 2020 TAX POLICY STUDY COMMISSION OF THE OHIO GENERAL ASSEMBLY

SENATOR BOB PETERSON AND REPRESENTATIVE JEFF MCCLAIN CO-CHAIRMEN

TESTIMONY
OF
MARK ENGEL
BRICKER & ECKLER LLP
OMA TAX COUNSEL

FEBRUARY 24, 2016

Senator Peterson, Representative McClain and members of the Commission, my name is Mark Engel. I'm the Partner in charge of Bricker & Eckler's Cincinnati-Dayton office. My practice is focused on taxation issues, with concentrated experience in all aspects of state and local taxation, including tax planning, compliance, and litigation in sales and use, income, commercial activity, public utility, and property taxation as well as economic development. I also serve as tax counsel for The Ohio Manufacturers' Association (OMA). I'm testifying today on behalf of OMA regarding tax expenditures and the Commercial Activity Tax (CAT). The OMA was created in 1910 to advocate for Ohio's manufacturers; today, it has 1400 members. Its mission is to protect and grow Ohio manufacturing.

Background:

For Ohio to be successful in a global economy, the state's tax structure must encourage investment and growth and be competitive nationally and internationally. A globally competitive tax system is characterized by (a) certainty, (b) equity, (c) simplicity and (d) transparency. Economy of collections and convenience of payment also are important considerations.

Prior to 2005, Ohio's tax structure was essentially unchanged since the 1930s. The major taxes were the real property tax, the sales and use taxes, the tax on tangible personal property used in business, and the corporation franchise tax measured on net worth. However, the franchise tax and the tangible personal property tax, especially, both hit capital-intensive industries harder than other industries and had to be paid whether the entity made, or lost, money. Thus, the manufacturing sector paid an inordinately high level of state tax when compared with other segments of the economy.

As services made up a larger share of Ohio's economy over the years, the inequality in the state tax burden between manufacturing and other segments of the economy was exacerbated. Many service sector concerns operate without a significant investment in capital; hence, their tangible personal property and net worth franchise tax liabilities were minimal. Many of these services operate on more slender margins or can manipulate their finances to minimize income; as a result, little income tax was generated. In addition, many of these new service entities were organized as pass-through entities that were not subject to the franchise tax. As the demand for state services grew, the only recourse was to raise existing tax rates on existing taxpayers. In many cases, that meant an increasing tax burden for Ohio manufacturers.

Paradoxically, Ohio continued to add exemptions from, and exceptions to, the various taxes during this time. As a result, Ohio was saddled with a number of taxes that had high nominal rates, but struggled to raise sufficient levels of revenue for governmental operations. The discrepancies between taxpayers and economic segments also increased and compliance with the existing taxes became more complicated.

The large and increasing number of exemptions and exclusions, added over the years in order to render the franchise, personal property and sales and use taxes less onerous, narrowed the bases of those taxes. Accompanied by the relentless rise in tax rates, the taxes were not only inefficient, but also discriminatory against businesses with heavy investment in capital.

Tax Reform Enacted

Over the years, calls increased to reform Ohio's tax system to render it more fair and competitive. Finally, in early 2005, true tax reform was proposed. The goals of tax reform were:

- Eliminate the taxation of investment and shift to the taxation of consumption;
- Broaden the over-all business tax base;
- Reduce over-all business tax rates;
- Improve fairness;
- Provide a more stable and predictable flow of revenue; and
- Simplify compliance.

The result was a comprehensive overhaul of Ohio's tax system by H.B. 66. As enacted, the bill:

- Eliminated the tangible personal property tax on new investment in manufacturing and phased out the tax on all general business property over 4 years;
- Phased out the corporation franchise tax for most corporations over 5 years;
- Phased in a 21% reduction in personal income tax rates ratably over 5 years (the last reduction was delayed 2 years in 2009 in an effort to balance the state budget, but was implemented in 2011); and
- Enacted the commercial activity tax ("CAT"), a broad-based, low-rate tax measured by gross receipts from virtually all business activities and entities.

H.B. 66 became law in June 2005. Although generally opposed to gross receipts taxes because of their compounding nature, taxpayers warmed to the CAT as the net savings over the former franchise and personal property taxes became clear due to the broad base, limited exclusions, and the low rate.[1] In addition, compliance costs were slashed as taxpayers no longer had to undertake the arduous process of preparing personal property tax returns or corporation franchise tax reports.

Many tax expenditures spring from the desire of policymakers to manage the economy, control economic behavior, or provide special favors through taxation. Regardless of how well-intentioned those efforts may be, tax expenditures can and do create undesirable consequences. They often reduce certainty, as many create questions as to who may benefit from them, and the extent of the benefit. They reduce equity, resulting in government picking winners and losers. Tax expenditures increase complexity and reduce transparency as taxpayers and tax administrators attempt to implement them. In short, they are bad tax policy and their use should be minimized. In fact, by minimizing them, the base is broadened and the need for special treatment is reduced.

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[1] Manufacturers remain the largest category of CAT taxpayers. See Exhibit A, attached.

CAT Tax Expenditures:

Tax reform notwithstanding, Ohio has continued on its relentless march towards more tax exclusions, even as it enacted the CAT, raised sales tax rates and broadened the base, and continued to cut income tax rates. As noted many times, some of the most important aspects of the CAT are its broad base, its low rate, and its broad application to virtually all business entities. Those attributes can only be maintained when the state stands firm against pleas for individual carve-outs and exemptions.

When it was first enacted, there were approximately 25 exclusions from the CAT and only four credits. The tax expenditure associated with those exclusions in 2010, the first year the tax was fully phased in, totaled approximately $300 million. Those exclusions were built into the tax as enacted and the 0.26 percent rate was established with those exclusions in mind.

In its fiscal year 2014 tax expenditure report, the Department of Taxation lists a larger number of exclusions and credits to the CAT. The CAT now lists approximately 36 exclusions and is subject to 7 credits. The total cost of those expenditures, without consideration of the credits, is over $600 million! Thus, in just 10 years, additional credits and exclusions were added to the tax that doubled the amount of the tax expenditure.

The CAT is a stable tax. Although it is a gross receipts tax that pyramids along the economic chain, it is tolerated because of its broad base and low, low rate. However, in less than 10 years, tax expenditures associated with the tax have doubled. One wonders how much longer chipping away at the base can continue before the calls to increase the rate become too loud to ignore. Ohio traveled down this path before with the franchise and personal property taxes. The trip was a disaster. Ohio should not venture down that path again with the CAT.

The CAT was enacted as a tax on commercial activity. All enterprises engaged in such activity should be paying the CAT; in fact, equality in the burden of taxation demands that they all remain subject to the tax. Exemptions, exclusions and credits violate the rule of equality and render the tax less clear and more complicated.

Sales and Use Tax Expenditures

Ohio's sales tax was first enacted as a temporary measure in the depths of the Great Depression in the 1930s. At that time, it was conceived as a tax on the final personal consumption of tangible goods. One year after initial enactment, the use tax was enacted, the two taxes were made permanent and the first exemption for machinery and equipment used to produce tangible personal property for sale by manufacturing was added. Similar exclusions were made for other activities that, similarly, resulted in the production of goods that would be subject to the tax upon final sale.

The rationale for these exclusions is simple: The taxes are intended to be imposed upon the final personal consumption of goods and, now, those selected services that are subject to tax. Intermediate transactions prior to the final sale of the product, including the acquisition of machinery and equipment and the raw materials that are incorporated into the final product, are not intended to be taxed.[2] The economic basis for this principle is four-fold:

First, imposing the tax on intermediate transactions (sometimes called business inputs) causes the tax to be imposed at each step in the production of a good. This causes the tax to pyramid at each step of the economic ladder, resulting in an effective tax rate that may be much higher than the statutory rate. For example, in conjunction with the 1994 tax study commissioned by the General Assembly, the staff provided an example in which a sales tax rate of 6.5 percent applied to two stages of production resulted in an effective tax rate of 9.5 percent at the time of the final retail sale.[3]

Second, imposing the tax on business inputs increases the cost of doing business through the higher costs that result from the tax. Business generally will respond to

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[2] The exclusion for business inputs does not mean that manufacturers do not pay significant amounts of sales and use taxes. See Exhibit B, attached.
[3] Roy Bahl, Ed., *Taxation and Economic Development: A Blueprint for Tax Reform in Ohio* (Battelle Press 1994), p. 277-278 (the "*1994 Staff Report*").

higher costs in a combination of three ways: It may decide to charge higher prices; it may pay lower wages to workers (or expatriate those positions elsewhere); or it may provide a lower return on investment to owners.[4] Such an impact by taxes on economic decisions should be minimized.

Third, direct inputs lead to the production of more valuable goods that are ultimately subject to the tax. Thus, the tax on the final product is maximized.

Fourth, the provision has economic development implications. Every single state that surrounds Ohio has a sales tax. Every one of those states has some sort of exemption from the tax for machinery and equipment used in the production of tangible goods to be sold by manufacturers. Moreover, the *1994 Study* also found that lower rates of taxation on business equipment increase the rate of business formation of smaller firms. Thus, imposing the sales tax on manufacturing machinery and equipment puts Ohio at a disadvantage from an economic development perspective and may actually reduce small business formation.[5]

The application of sales and use taxes to business inputs has been the subject of comment on at least two prior occasions in which taxes in Ohio were studied. In 1982, the *Final Report and Recommendations of the Joint Committee to Study State Taxes* (114th General Assembly, December 1982), pp. 15-16 concluded that sales and use taxes should be imposed broadly on consumer spending, but very selectively on business spending. Similarly, the *1994 Study* at p. 5-4 and the *1994 Staff Report* at p. 27 both recognized that the sales tax should only be imposed upon the final consumer and that business inputs should not be taxed at all. The taxation of business inputs should be avoided because doing so leads to multiple levels of taxation and economic disadvantages. Moreover, the *1994 Report* concluded that if the sales tax is extended to services, there should be liberal exemptions for transactions between businesses.

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[4] *Taxation and Economic Development in Ohio: A Blueprint for the Future*, Final Report of the Commission to Study the Ohio Economy and Tax Structure (December 23, 1994), p. iii ("*1994 Study*").
[5] *Id*., at p. 5-4.

The taxes are intended to apply to final, personal consumption. When the taxes were conceived, that meant primarily the purchases of tangible personal property by individuals. While some business purchases, such as office equipment and supplies, were subjected to taxation, business inputs that contributed to the production of a product, the sale of which would subsequently be subject to sales or use tax, were excluded. Other than the sale of food, few other exemptions existed.

Over the years, a number of exclusions have been added to the taxes. While many of them represent transactions involving business inputs, a majority of them represent exclusions of another nature. Today, R.C. 5739.02(B) contains 53 subdivisions providing for exclusions from the tax. One subdivision alone, subdivision (B)(42), contains 15 separate exclusions! Other exclusions are scattered throughout the Revised Code. And, this does not include the number of consumer services that are not even included in the tax base.

Business consumption is taxed under the CAT. The sales and use taxes are intended to apply to personal consumption of final goods and services. If the bases of those taxes are broadened accordingly, especially with respect to services, and exclusions and exemptions are limited, the rates can be lowered, further reducing the need for additional exclusions.

Personal Income Tax Expenditures

The personal income tax was enacted in the early 1970s as an additional, stable source of revenue. Over the years, the number of exclusions and credits has mushroomed as well, and the rates were driven upwards. Even though rates have dropped about 35 percent since the 2005 tax reform, R.C. 5747.01(A) still provides for about 22 deductions or exclusions for calculating Ohio taxable income. R.C. 5747.98 lists 38 separate credits that may be taken against the tax.

Many exclusions and deductions to the sales and income taxes have a social basis. The personal income tax credit for retirement income and medical premiums are just two examples. Many exclusions serve laudatory purposes, but the result is a system of taxes that is complicated, favors some taxpayers over others, and results in ever-higher tax rates on those who are left paying the bills. Ohio may be further ahead to lower the rates and let everybody help pay for the government services that they all use.

Summary:

Since the enactment of tax reform in 2005, OMA has maintained a principled, consistent approach to tax policy in Ohio. That approach insists on certainty, equity, simplicity, and transparency. The erosion of the tax reform legislation, in the form of carve-outs, exclusions, and ear-marks, reduces certainty, creates disparity by selecting winners and losers, renders the tax code more complicated, and reduces transparency as it becomes more difficult to determine who is entitled to which exclusions.

Everybody has a story; everybody has a reason why one tax or another is not fair to them. However, one cannot have an efficient and fair tax system that is different for every taxpayer. Nor is it fair to tax some segments of the economy at levels that are 10 times higher than those imposed on other segments. The 2005 tax reform legislation was directed at trying to reduce that inequity on a tax system-wide basis. Every time an exclusion or exemption from the CAT, the sales and use taxes, or the personal income tax is created, that increases the tax burden on everybody else. The solution isn't a tax system made of Swiss cheese; we tried that already, and it didn't work.

It is time to stop the madness. Rather than continuing to enact exclusions that render the taxes less and less fair, more and more complicated, and result in higher and higher tax rates for taxpayers, OMA suggests that a better approach may be to broaden the bases as appropriate, reduce the number of exclusions and reducing over-all tax rates. If rates are reduced, the necessity for the special tax treatment afforded by exclusions that are not economically based, and that are contrary to the very purpose of the tax, is reduced significantly. The result is a tax system that comprises one or more taxes with a broad base, a low rate tax, that is simple to enforce and simple to follow, and that treats all taxpayers the same.

Thank you very much for the opportunity to appear here today. I'd be pleased to answer any questions that any of you might have.

EXHIBIT A

CAT and Manufacturers:

According to Ohio Department of Taxation Fiscal Year 2015 Commercial Activity Tax Returns data, manufacturers made up the second-largest group of CAT taxpayers, representing 10.5% of all taxpayers (retail trade is the largest).

And, manufacturers pay 26.1% of the state's total – far more than any other group (in terms of CAT revenues based only on the 0.26% CAT rate for gross receipts in excess of $1 million).

In addition, CAT filers with taxable gross receipts of $1 million or less accounted for 66.3% of all filers in fiscal year 2014, but less than 1% of the total liability for that period.

EXHIBIT B

Sales Tax and Manufacturers:

Despite the exemption for machinery and equipment enjoyed by manufacturers, this does not mean that manufacturers do not pay sales and use taxes in Ohio. Manufacturers purchase and use many goods and services that are not included in the manufacturing exemptions. Those items include machinery and equipment that is used before manufacturing begins, or after it ends; cleaning equipment and supplies; maintenance and repair equipment and supplies; storage facilities; most safety items; and office supplies and equipment and motor vehicles. It also includes automatic data processing, computer and electronic information services, and temporary employment and employment placement services. As a result, manufacturers pay millions of dollars in sales and use taxes annually to the state of Ohio.

According to the 2015 Annual Report of the Ohio Department of Taxation, manufacturers as an economic segment paid more than $426,000,000 in sales and use taxes directly to the state of Ohio. This is in addition to the untold millions of tax dollars that were paid to, and reported by, vendors and retailers located in Ohio. It appears that in terms of tax owed to the state, as opposed to tax that is collected from others, manufacturing is one of the largest payers of sales and use taxes in the state.

Foregone Revenue from CAT Exclusions, Deductions and Credits

Below are estimates of revenue foregone in FY 2017 by the state General Revenue Fund from various CAT exclusions, deductions and credits.[1] Dollar amounts are millions.

Exclusion of first $1 million of taxable gross receipts	$267.8
Qualified distribution center receipts exclusion	$164.6
Job creation credit	$88.1
Job retention tax credit	$29.6
Credit for increased qualified research and development expenses	$28.6
Agricultural receipts	$14.0
Casino receipts in excess of "gross casino revenue"	>$10.0 [2]
Credit for net operating loss carry forwards and other deferred tax assets	$7.1
Professional employer organization exclusion	$5.4
State and federal cigarette tax exclusion	$3.5
Consumer product integrated supply chain exclustion	$3.0[3]
Motor vehicle transfer exclusion	$2.0
Exclusion of certain services to financial institutions	$1.9
Exclusion of real estate brokerage gross receipts not retained	$1.5
Research and development loan program credit	$1.5
State and federal alcoholic beverage excise tax exclusion	$1.1
Exemption for pre-1972 trusts	<$1.0 [4]
Anti-neoplastic drug exclusion	<$1.0
Horse racing taxes and purse exclusion	<$1.0
Receipts from sale of uranium from qualifying uranium enrichment zone	<$1.0
Providing public services exclusion	No Estimate Available
Petroleum receipts [5]	No Estimate Available
Motion picture credit	No Estimate Available
Estimated Total Foregone Revenues	**More than $629.7 million**

NOTE: Actual total foregone revenues will be higher than estimated total forgone revenues, which reflect indefinite revenues for casino receipts and undetermined revenues for the public services exclusion, petroleum receipts and motion picture credit.

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[1] Unless otherwise noted, the source for the data listed above is the Ohio Department of Taxation Tax Expenditure Report (Fiscal Years 2016-2017).
[2] Ohio Legislative Service Commission estimates foregone revenue from casino receipts in excess of "gross casino revenue" will be "tens of millions of dollars."
[3] Ohio Legislative Service Commission, Senate Bill 208 Fiscal Note as Enacted, 2015.
[4] The Ohio Department of Taxation Tax Expenditure Report provides only general "less than $1 million" estimates for six items in this list (rather than precise estimates as provided for the other items). For this reason, we have chosen not to include any foregone revenue for the six items with estimated foregone revenues of less than $1 million each.
[5] Motor vehicle fuel dealers pay a one-time tax of 0.65% on their sales of petroleum products.

BEFORE THE OHIO 2020 TAX POLICY STUDY COMMISSION
TESTIMONY ON TAX EXPENDITURES
WEDNESDAY – FEBRUARY 24, 2016

Co-Chairs Senator Peterson and Representative McClain and Members of the Commission,

My name is Daniel Navin and I am the assistant vice president of tax & economic policy for the Ohio Chamber of Commerce. I am here today to share the Chamber's thoughts on "tax credits/expenditures" per the charge to the Commission in last session's House Bill 64 "to review and evaluate all tax credits authorized by the state".

Before I go any further, I want to tell the Commission my remarks today will largely be confined to tax expenditures, per se. I have met several times with my own Ohio Chamber Tax Committee and have other recommendations to make regarding other aspects of Ohio's tax structure. I trust at some future time I will have the opportunity to present those suggestions.

As many of you know, I have testified on the general subject of tax expenditures, and on specific pieces of legislation touching on this subject, several times over the past three or four years. Not wanting to reiterate all of what I have said previously, let me summarize our perspective. First, we initially came out in support of a periodic review of the effectiveness of state credits, exemptions and deductions back in 2010, along with the eight metro chambers of commerce, in a report entitled *Redesigning Ohio: Transforming Government Into a 21st Century Institution*. It was probably the most surprising recommendation among the ten we made.

Second, to ensure that the tax expenditures to be reviewed are meeting their intended policy outcomes and worth their price, we made more specific suggestions as follows:

a. Utilize the tax policy principles of neutrality, economic competitiveness, stability, equity and simplicity to conduct a thorough review and cost-benefit analysis of the 128 tax expenditures in the state budget;
b. Use both a static and dynamic analysis of the costs and benefits of tax expenditures; and,
c. Improve the quality and scope of Ohio's biennial Tax Expenditure Report.

We place great emphasis on b. – the need for dynamic tools to measure the statewide and/or local economic impact, not solely the tax dollars foregone that is the only current measure, to assist in the expenditure review process. We believe that if a tax expenditure review is worth doing – and we believe it should be done and done properly – then it cannot be done halfway. The process must have all the necessary measuring tools, analytical models and funding to generate a comprehensive but fair breakdown of the merits and possible shortcomings of each tax expenditure.

Third, most tax expenditures fall under one of the following categories or rationales:

- They are constitutionally required;
- They exclude a "necessity", such as food, from taxation;
- They enhance Ohio's incentives to invest in manufacturing equipment (sales tax exemptions for property primarily used in manufacturing or packaging) or locate businesses in targeted economic development areas (enterprise zones); or,
- They limit double taxation/pyramiding (resale sales tax exemption).

One or more of these criteria explains or constitutes a plausible reason for the enactment of many if not most of the 128 tax expenditures. For example, the largest tax expenditure in the biennial report is the sales tax exemption for the sale/purchase of tangible personal property primarily used in manufacturing, with the static estimate of foregone revenue of approximately $1.9 billion.

Originally enacted in 1935 when Ohio was a manufacturing powerhouse, the exemption was almost certainly intended to protect Ohio manufacturers from having to pay a 3% sales tax (now between 6 – 8%) on items purchased at each stage of the manufacturing process that are ultimately incorporated into the completed product. The purpose of the exemption is to prevent pyramiding of that 6 – 8% sales tax at each stage and is especially important, for obvious competitive reasons, to the state's manufacturing sector, their employees and the state's overall economy since many manufacturers in Ohio are part of an Ohio-based multi-tier supply chain. The sales tax manufacturing exemption clearly provides critical support for an absolutely essential part of Ohio's economy – comprised of over 17,000 manufacturers, 883,000 manufacturing jobs, and just under $90 billion in gross state product, according to the 2015 Ohio Manufacturers' Directory published by *Manufacturers' News* – and is undeniably "worth the price".

Fourth, the Ohio Chamber's Tax Committee set other more specific parameters for our support of any tax expenditure review legislation. Those are that:

1. There be a significant time for the review of all tax expenditures, and not every two years as part of the biennial budget process;
2. The tax expenditure review committee not have the authority to terminate or sunset any tax expenditures;

3. There be a dynamic analysis of each tax expenditure under review of its benefits and effects on Ohio's economy; and,
4. There be some representation of private sector tax experts as members of the review committee.

Up to now I haven't mentioned private sector representation, particularly individuals with tax-related expertise, on the review committee. However, this is an important issue for Ohio Chamber members, as we believe private sector tax experts are better equipped to bring to the forefront the importance and relevance businesses place on economic competitiveness and tax structure stability. Our concern is that those tax policy principles may get lost or be given short shrift if private sector tax experts are excluded from the review committee.

Finally, our preference is to continue advocating for and making recommendations to develop a well-defined tax structure that adequately funds state services and citizen (including business) needs, and not to create new or additional tax expenditures. I want to reiterate that an important part of that effort is the establishment of a tax expenditure review process that has all the necessary tools, analytical models and funding to generate a comprehensive yet fair breakdown of the merits and shortcomings of each tax expenditure.

Our current way of looking at tax expenditures only takes into account one side of the story – how the tax expenditure affects the state's general revenue fund. There are broader implications to the state economy and local/regional economies that have to be considered in evaluating the utility and effectiveness of tax expenditures. We think a rigorous, balanced, periodic review of tax expenditures is a key component of moving toward a more fair and more competitive tax structure in Ohio.

Sen. Peterson and Rep. McClain, that completes my testimony and I will be happy to answer any questions the commission members may have.

NFIB
The Voice of Small Business®

TESTIMONY BEFORE THE OHIO 2020 TAX POLICY STUDY COMMISSION

INTERESTED PARTY

FEBRUARY 24, 2016

Chairmen McClain and Peterson and members of the 2020 Ohio Tax Policy Study Commission, my name is Chris Ferruso and I serve as Legislative Director for the National Federation of Independent Business/Ohio (NFIB/Ohio). I am here on behalf of the nearly 25,000 governing members in this state to discuss some core principles on taxation and how those relate to tax expenditures.

By way of background, my typical member employs 20 or fewer and does under $1 million in gross receipts on an annual basis. My members come from all industry sectors with the preponderance in the retail, service, manufacturing, agriculture and construction sectors. Any formal position we take on legislation is directly tied to our member ballot/survey process. That is to say our members set policy on behalf of the organization. We believe our unique surveying method allows us to truly get a feel for the sentiments of small business.

When surveying broad-based business issues, taxes continue to rank amongst the top concerns/challenges faced by our members and the small business community as a whole. There are several underlying or guiding principles a majority of our members have indicated dictate their view of a quality tax system.

First, stability and predictability are important factors in allowing small-business owners the ability to plan. When government frequently changes the rules, it creates less confidence for entrepreneurs to grow.

Second, any tax system needs to be simple in both compliance and administration. In addition to actual liability, compliance costs can be, and many times are, more substantial to small-business owners.

Third, government should not be in the business of trying to promote desirable economic behaviors. The more preferential treatments involved, the less equitable a tax is.

Fourth, while taxes must be competitive to make Ohio attractive for relocating businesses, they are just as important for retaining our existing businesses.

Fifth, reform needs to be achieved in a well thought out manner with a thorough analysis of potential impacts (both positive and negative).

Sixth, any change in tax policy should be transparent, so throughout the supply chain the tax being applied is recognizable.

Finally, it is counterintuitive to raise taxes on one segment of the business community to pay for a tax cut for a different segment; government should not be picking winners and losers among businesses.

With respect to tax expenditures, as we have indicated previously in testimony in both the Ohio House and Senate, we believe it is appropriate to conduct a dynamic analysis of those currently in law. However, we caution moving forward with any proposal that would include an automatic sunset, be it every 5 or 10 years, is not sound tax policy and creates uncertainty. We are cognizant of total costs associated with Ohio tax expenditures; however we strongly believe simply eliminating any tax expenditure without fully understanding the economic consequences would be premature.

Many tax expenditures aim to eliminate the pyramiding or compounding effect of taxing goods multiple times through the production phase, particularly with respect to sales tax. When reviewing the Tax Expenditure Report issued by the Ohio Department of Taxation that coincides with the state operating budget, the largest amounts associated with sales tax expenditures are predominantly for tangible personal property used in the production of goods or services. These important expenditures ensure production of goods are not saddled with multiple layers of taxation. Instead, it is paid by the consumer at the final point of sale. This process ensures transparency to the end user and does not mask taxation. These expenditures are critical to keeping Ohio competitive as many states allow similar treatment.

In 2013, the NFIB Research Foundation published a survey, *Taxes and Spending: Small Business Owner Opinions*, to garner our members' opinions on tax policy. I have included a copy of this survey so you may peruse at your leisure. In general, our members are amenable to the idea of reducing the number of expenditures so long as the end result is a reduction in total tax liability. They are not in favor of seeing expenditures used to fund additional growth in government. Please note, this survey was conducted nationwide and did not drill down into specific expenditures in Ohio. As part of our member driven process, we plan on ascertaining a better understanding of NFIB/Ohio members thoughts on Ohio specific tax expenditures over the course of the summer. Any pertinent information will be shared with this committee.

Thank you for the opportunity to appear before you today. I would be happy to try and address any questions.

NFIB | Research Foundation
The Voice of Small Business.

TAXES AND SPENDING:

SMALL BUSINESS OWNER OPINIONS

March, 2013

http://www.nfib.com/taxsurvey2013

EXECUTIVE SUMMARY

*Eighty-five (85) percent of NFIB (National Federation of Independent Business) members think Congress should fundamentally revise the federal tax code in 2013.

*Arbitrary/inconsistent tax preferences, constant change, and complexity top the NFIB member list of complaints about the current federal tax code.

*NFIB members have effectively surrendered to the code's complexity. Ninety-one (91) percent hire a professional tax-preparer to do their taxes. Fifty-five (55) percent do not think simplification will occur in any tax revision, even if explicitly intended.

*Thirty-four (34) percent of NFIB members made expenditures in the last five years to protect their heirs from the estate tax; another 15 percent plan to make them. Since many fewer will ultimately require the protection, those expenditures represent a considerable misallocation of resources.

*At least 82 percent of NFIB members purchased less than $500,000 in depreciable business assets, including real property, in 2012.

*Thirty-six (36) percent of NFIB members say that they calculated the Alternative Minimum Tax (AMT) in their last tax year; 17 percent claim that they paid it.

*NFIB members in the abstract strongly prefer a tax code with lower rates and fewer preferences. They are less inclined to hold those views when concrete proposals are in question.

*Tax preferences that NFIB members generally support capping or eliminating *in exchange for lower tax rates* include: the mortgage interest deduction; the employer-provided health insurance exclusion; total deductions; tax exempt municipal bonds; and the production tax credit. Where applicable, one-third to one-fourth of respondents selected their answer based on a provision's cap size rather than the provision per se.

*NFIB members favor retaining the deduction for state and local taxes paid, even in exchange for lower tax rates, and the preference for capital gains.

*To reduce the federal budget deficit, 81 percent prefer a spending cut to tax increase ratio of at least 3 to 1, with the emphasis on cuts. A plurality (36%) wants to reduce the federal budget deficit through spending cuts *only*. Virtually no respondent favors more tax increases than spending cuts.

*NFIB members oppose the VAT and the Carbon Tax as potential replacements or offsets for other taxes by a net 41 percent and 64 percent, respectively.

*The success measure of fundamental tax restructuring for a majority of NFIB members is the bottom line. Seventy-one (71) percent agree that the most important outcome in tax restructuring is their taxes rising or falling; 20 percent disagree.

Contents

NFIB members think that Congress should fundamentally revise the federal tax code in the next year (2013). Fifty-five (55) percent *strongly* favor fundamental change in 2013 and another 30 percent simply favor it (85% in total). Just 6 percent oppose fundamental change in the next 12 months. The remainder either are undecided or did not respond. The population therefore not only supports change, but finds some urgency to the matter.

NFIB member views on the need to restructure the tax code are predictable; tax reform is always popular.[1] The critical issue is the nature of change. Any fundamental change to the tax code has, and will likely continue to be, a balance between the desire to achieve a more rational code and self-interest, that is, in keeping personal taxes as low as possible. Thus, restructuring the tax code is difficult under the best of circumstances. Yet, NFIB members think that fundamental tax change should be part of a larger effort to bring the federal budget deficit under control; they think of the two as inextricably linked. Sixty-two (62) percent see fundamental tax reform as part of an overall deficit reduction effort, 42 percent strongly so. Twenty-nine (29) percent disagree, 14 percent strongly. The latter group thinks the two should be addressed separately.

Readers should note before proceeding that the overwhelming majority of small-business owners pay taxes on their business income as "pass-throughs," not as the more traditional C-corporation (and then again as an individual). Twenty-one (21) percent of NFIB members own C-corporations with the remainder owning pass-throughs, that is, proprietorships, partnerships, S-corporations, or limited liability corporations. The most common pass-throughs are S-corporations owned by 45 percent of respondents.

The following pages report on the nature of tax code changes that NFIB members prefer and related matters.

Issues in the Current Federal Tax Code

NFIB members identify multiple issues as their major sources of complaint with the existing code. For example, the survey presented respondents seven potential problems with the current federal tax code and asked them to identify which were the TWO most troublesome aspects. Their answers appear on Table 1 below. The most frequent complaint is that the deductions, deferrals, credits, and exclusions in the code are inconsistent, arbitrary, and politically-motivated. In other words, the current system of tax preferences makes no sense. Forty-eight (48) percent exercised one of their two allowable choices on that aspect of the code.

The second most frequently identified aspect (by 42%) was constant change. While there is something anomalous in demanding change and then complaining that change occurs too frequently, the basic issue is likely predictability, certainty, and knowing in advance the rules under which they will be playing. The tax uncertainty that has been endemic over the past several years is only the most egregious in a very long list of tax-uncertain moments. That situation likely caused respondents to identify the "change problem" more often than they would have during more normal economic times.

Thirty-six (36) percent chose complexity. Complexity arises at several points later in the text. However, it should be noted here that small-business owners typically do not personally do their taxes; they pay others do it for them. Complexity is therefore principally an after-the-fact business expense that effectively dilutes the behavioral incentives built into the code. Thirty (30) percent complain that rates are too high. NFIB members historically often conflate the amount of tax paid with the structure of the tax code. This is just the first example in the current survey.

[1] The terms used throughout the remainder of the text are "change," "revision," and "restructuring" of the tax code. The term "reform" is not used because it is interpreted differently by different people.

Another 17 percent of respondents report that taxes adversely influence business decisions. Sixteen (16) percent say tax rates are too progressive. As written comments indicate, a number of respondents are proponents of the flat tax and/or the fair tax. Finally, 7 percent complain that the current code does not raise enough revenue. One important tax principle is adequacy, that is, the tax system should produce adequate revenues to pay for expenditures made. A correlation appears between members directly worried about adequacy and those willing to cut the federal deficit relying on a modestly higher percentage of revenues than others. The remainder typically provided only one of their two possible answers.

Table 1 presents NFIB member views on the worst aspects of the current tax code by the legal form of the businesses they own. Seventy-seven (77) percent of respondents are pass-through entities, 21 percent C-corporations, and 2 percent unknown. The table shows few differences in the views of these two types of owners on the primary shortcomings of the current tax code. This will be a recurrent theme throughout the remainder of these pages. Legal form of business is not associated with NFIB member evaluations of tax issues.

Table 1
Worst Aspects of the Current Tax Code by Legal Form of Business*

Aspects	Proprietor-ships	Partner-ships	S-Corps	C-Corps	LLCs	Total[†]
Constant Change[a]	50.0%	*i*	37.3%	43.7%	44.6%	41.6%
Rates Too Progressive[b]	10.2	*i*	16.9	16.9	17.3	15.7
Arbitrary/Inconsistent Preferences[c]	46.3	*i*	46.2	52.8	45.3	47.5
Doesn't Raise Enough Money[d]	6.5	*i*	7.5	6.3	5.0	6.8
Tax Rates Too High[e]	30.1	*i*	29.8	27.2	29.5	29.5
Complexity[f]	31.0	*i*	38.5	34.6	39.6	36.1
Taxes Affect Business Decisions[g]	19.0	*i*	16.1	14.6	18.0	16.9
Other	2.3	*i*	2.1	1.2	--	1.7
N/A[‡]	4.6	*i*	5.6	2.7	0.7	4.2
Total	200.0%	200.0%	200.0%	200.0%	200.0%	200.0%
N	216	37	533	254	139	1198

*Respondents could make two choices.
[†] Includes partnerships and those who did not identify a legal form.
i Insufficient number of cases to report totals.
[a] Constant change makes planning and compliance difficult.
[b] Rates are too progressive (too much difference between low tax brackets and high ones).
[c] Deductions, deferrals, credits, and exclusions are inconsistent, arbitrary, and politically-motivated.
[d] Doesn't raise enough revenue to pay for government costs.
[e] Tax rates are too high.
[f] Complexity raises compliance costs and muddles possible tax incentives.
[g] Tax considerations unnecessarily affect business decisions.
[‡] Includes those who made only one selection.

A second aspect of NFIB member views on the tax code are specific items that they would like to see addressed in a fundamental tax revision. Their highest priorities among those tax items of particular small business interest include a reduction in complexity (52%), repeal of the estate and gift tax (45%), full expensing (25%), no net tax increase (25%), repeal of the AMT (Alternative Minimum Tax) (19%), elimination of corporate dividends for C-corporations (12%), and reduction in tax rates (11%).

a. Complexity

Complexity is an on-going problem. However, small-business owners appear to have thrown up their hands and surrendered to it. When asked what part of the code is the most complex or complicated for them and their business, the majority (52%) report that they let their tax professional worry about complexity; they will pay for the help they need. This survey's results show that the largest consequence of complexity is the additional business expenses associated with hiring tax professionals and related costs. Those who do cite a specific part of the code agree on little. For example, 12 percent identify depreciation, 9 percent capital gains, 7 percent AMT, 5 percent inventory accounting rules, 4 percent passive income, 4 percent pension rules, and 4 percent quarterly filings. Two percent volunteer something else and 2 percent did not respond. Tax simplification for small businesses will require a comprehensive review of the contribution made by various code provisions to complexity; there is no simple, single fix. True simplification of the current code for small businesses, if possible, requires substantial change in many relevant code provisions.

NFIB members are not optimistic that complexity can/will be reduced. Fifty-five (55) percent do not think it will happen, regardless of intent to do so. Thirty-three (33) percent disagree. The remainder have no opinion. This tally suggests a certain cynicism over the likelihood that simplification can or will occur. The survey did not solicit whether that cynicism is bound to the difficulty of actually doing so, experience, or that a priority will ever be assigned to the task.

A simpler tax code equates to administrative cost savings for taxpayers. One reasonable measure of tax simplification therefore is whether small-business owners pay less for professional tax preparation. Another is a reduction in internal administrative expenses on tax matters, an outcome often difficult to measure. So, would NFIB members be willing to exchange minor tax increases for savings from tax simplification? The answer is "no". Sixty-three (63) percent would accept no tax increase as compensation for a simpler income tax system, though 14 percent would not complain about a one percent increase, 6 percent a two percent increase, and 2 percent a five percent increase. Twelve (12) percent have no opinion and 3 percent did not answer. Since the trade probably represents a good financial deal for business owners, why are they unwilling to take it, at least in concept? A possible explanation is their suspicion that the code will never be less complicated. More likely, they think that they should not have to pay for a less complex code; a complicated code should not exist in the first place. Regardless, the results underscore the deep skepticism NFIB members possess over the likelihood of a policy outcome that seems so basic.

b. Estate and Gift Tax

The immediate economic impact of the estate tax stems from expenditures made today in order to protect assets that could be taxed in the future. Thirty-four (34) percent claim that they have incurred expenses in the last five years, such as financial planning, purchase of insurance they would not have otherwise, etc., in order to protect themselves/their heirs from estate tax liability. Another 15 percent did not make such expenditures in the last five years, but expect to do so in the future. In contrast, 45 percent neither have made any expenditure nor have plans to make any. Another 4 percent explicitly say that do not intend to pass on the business. The survey did not gather the amount or the nature of expenses incurred.

The current size of the NFIB member's business is directly related to his/her propensity to make expenditures in anticipation of the estate and gift tax's demands. Owners of larger, small businesses are more likely to engage in the activity than owners of smaller, small businesses. For example, half of businesses annually grossing $5 million or more made protective expenditures in the last five years and another 16 percent plan to do so in the future; the number who completed their planning and consequently have incurred no recent expenditures is not known. This figure contrasts with the one-quarter annually grossing between $250,000 and $499,999 who have made such expenditures in the last five years, though another 16 percent plan to make them.

There is little reason to think that 34 percent of NFIB members will eventually have estates large enough to require steps necessary to protect themselves from the estate tax. Even if the tax did not apply to estates of $5 million in assets or less, a much smaller number statistically will incur the tax than are planning for it. Possible reasons for the large number of small businesses planning for the estate tax are that some businesses (estates) will not grow large enough to incur a tax; some businesses will disband; some will not have heirs who want to operate the business; etc.[2] However, that is not the point. The point is that individual small-business owners make decisions thinking that they may incur the tax (whether or not they ever do). That means a large portion of them make unnecessary, even wasteful, expenditures on products and services they may never require, depriving the business of investment capital that could more productively be used for other purposes, including business growth.

Uncertainty regarding the estate and gift tax over the last decade has clearly exacerbated the problem. A final determination of the tax's status should considerably reduce unnecessary expenditures to prepare for its demands.

c. Full-Expensing

Expensing is a means of depreciating business assets the same year they are purchased. It has two principal advantages for small businesses: expensing is much easier to calculate than other depreciation methods as it allows eligible assets to be "expensed", that is, deducted for tax purposes in the same year that the assets were purchased (paid). Expensing also accelerates the deduction compared to other depreciation methods thereby initially improving cash flow, though not affecting total taxes paid over an asset's lifetime. Assets eligible for expensing are typically business equipment, business vehicles, off-the-shelf software, etc. Although limited expensing for real property,[3] and its improvements is in place for 2013, it was not eligible for 2012 when the survey was conducted.

With the passage of the *American Taxpayer Relief Act of 2012* retroactive to tax year 2012, Section 179 expensing allows up to $500,000 of eligible assets to be expensed, at which point the Department of Treasury begins to recapture the benefits afforded by the provision. A complete phase-out (recapture) is reached at $2 million. However, these dollar limits are temporary, again illustrating a phenomenon noted earlier. Starting in 2014, the amounts revert to $25,000 and $200,000 respectively.

The majority of NFIB members purchased less than $50,000 of depreciable business assets in the last year, *including* real property and its improvement(s). Thirty (30) percent purchased less than $10,000 in depreciable business assets; 23 percent between $10,000 and $49,999; 12 percent between $50,000 and $99,999; 11 percent between $100,000 and $249,999; 6 percent between $250,000 and

[2] It is also possible, if not likely, that the uncertain outlook over the fate of the estate and gift tax over the last few years, including its threshold and rates, caused small-business owners to seek protection from the tax's consequences more frequently and incur larger expenditures than they would have under more stable conditions.

[3] Under the *American Taxpayer Relief Act of 2012* Pub, L. No. 112-240, up to $250,000 in real property improvements can be deducted under Section 179. The improvements are limited to certain retail, restaurant, and leasehold improvements.

$499,999; 3 percent between $500,000 and $999,999; and 2 percent $1 million and over. Thirteen (13) percent offered no response.

Eighty-two (82) percent of all NFIB members fell under the $500,000 threshold currently in place for 2013. That figure is likely low because of non-respondents (13% of the population). Virtually all of those remaining fell under the $2 million cap, making them eligible for at least a partial benefit. Most NFIB members' needs are therefore satisfied for 2012 and 2013. But, the Section 179 limits change in 2014 and with those changes, the utility of the provision's prior benefits. The 2014 limits mean that only 30 percent will receive the full benefit and another 23 percent (at most) will receive a partial benefit. Moreover, last year, the year for which the investment data were obtained, was not a "normal" year for small business investment.[4] When small business investment recovers and reaches more traditional levels, the 2014 expensing limits will dampen the provision's value more than it otherwise might. The precise number losing eligibility between 2013 and 2014 cannot be determined, but it will lie somewhere between one-half and one-third of the NFIB member population.

Survey results also show the increasingly diminishing small business benefit in raising Section 179 expensing levels above the current $500,000 threshold. Only 6 percent of NFIB members purchased more than $500,000 in depreciable assets in 2012. However, that does not preclude its value to medium-sized firms.

d. AMT

The Alternative Minimum Tax (AMT) is an alternative income tax system that parallels the federal personal income tax. It was designed to ensure that wealthy people who would have no income tax liability under the conventional system would pay at least some income tax. Covering just a handful of taxpayers initially, 4 million pay the AMT (2010), and several million additional taxpayers must calculate the tax even if they do not have to pay it.[5] Thus, the parallel system effectively creates a two-step process for those potentially required to pay the tax. The first calculation determines which tax system is applicable; the second calculates the extra amount of tax that AMT taxpayers owe.

Thirty-six (36) percent of NFIB members report that they had to calculate the AMT for their last tax year. Twenty-eight (28) percent say that they did not and 31 percent could not recall. The large number who did not recall should not be surprising given the overwhelming use of professional tax-preparers. In many cases, professional tax-preparers simply went ahead and made the calculation as part of the tax-preparation process; the taxpayer would have no reason to know whether the tax professional did so unless he had to pay the tax or the calculation was itemized separately on the invoice. The percent who made the calculation (had it made for them) is therefore likely to be higher than just the 36 percent who responded affirmatively.

Seventeen (17) percent say that they paid the AMT last year. That is a rate much higher than for the population as a whole. The reason is that the AMT most commonly hits married taxpayers in the $200,000 to $1 million income category who have "too many" tax deductions. Still, the 17 percent in this sample seems high, not only because of the proportion earning $200,000 or more, but also because only an estimated 54 percent of those earning between $200,000 and $499,999 are subject to the AMT.[6]

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[4] See, *Small Business Economic Trends*, NFIB Research Foundation, monthly. www.nfib.com/ResearchFoundation. The report, for example, shows that in January 2007, 62 percent of NFIB Members make capital expenditures in the prior six months. By December 2012, that number had fallen to 52 percent or about 16 percent lower (in frequency) than six years earlier.

[5] Justin Bryan, "Individual Income Tax Returns, 2010," *Statistics of Income Bulletin*, Fall, 2012, pp. 5-78.

[6] Urban-Brookings Tax Policy Center, Microsimulation Model, as presented in John D. McKinnon, "Millions Face a Hit if Fix for Minimum Tax Fails to Pass, *Wall Street Journal*, updated December 20, 2012.

A number of plausible reasons could explain an over-estimate, including payment in a prior year, but not 2012; payment of substantial tax; confusion between calculation and payment; and, lack of tax-preparer clarity in explaining a return.

Preferences versus Rates

Neutrality is generally considered an important tax principle. Yet, legislative bodies commonly use the tax code to promote (encourage) desirable social and/or economic behaviors. The result is a constant tension between tax provisions and proposals primarily designed to raise revenues while minimizing distortions to economic decision-making and those designed to encourage specific economic and/or social behaviors.

NFIB members, at least in the abstract, overwhelmingly favor a code that minimizes tax preferences and maximizes tax neutrality. Seventy-eight (78) percent think the code should have fewer preferences and lower rates, 52 percent strongly; just 3 percent choose the alternative. Eighteen (18) percent offer no opinion. However, a gap frequently exists between abstract principles and tangible outcomes, particularly when those tangible outcomes directly impact the respondent.

Table 2 presents data that examines specific tax preferences that impact many taxpayers, including small-business owners, to determine whether NFIB members would exchange those preferences for their monetary equivalent in lower rates. The latter proviso is critical. While Table 2 makes clear that NFIB members are willing, often eager, to eliminate or cap preferences in favor of lower rates, data sprinkled through this report make it clear that they do not share the same enthusiasm for tax increases under any circumstances. The most emphatic of these is the question indicating that the most important outcome of a fundamental tax restructuring is that their tax bill is no higher than before, a question which is subsequently addressed.

NFIB members evaluate each tax preference presented to them very differently. Huge majorities would trade the equivalent in lower rates for certain significant preferences while they would not for others. Familiarity with a tax preference often appears to shape the outcome. For example, 24 percent indicate that they are uncertain or have insufficient information about the desirability of capping total deductions in exchange for lower rates. The proposal is relatively new to the public, and hence it is likely that many do not fully understand it or have not thought much about it. But for the most part, the outcome for each preference evaluated is related to other factors, the most important likely being self-interest and distaste for the current condition.

a. Mortgage Interest

The survey directed three questions to mortgage interest deductions. The largest margin (net 54% in favor) of the eight preferences examined is capping the mortgage interest deduction on a primary residence at $500,000. Seventy-three (73) percent favor the exchanging the preference for a lower rate while 18 percent oppose it. The support, let alone its size, surprises given that small-business owners are much more likely to own homes than does the general population. Approximately 90 percent of employers own their primary residence.[7] Further, the industry most dominated by small business is

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http://online.wsj.com/article/SB10001424127887324731304578191863373273492.html.

[7] See, *Small Business, Credit Access, and a Lingering Recession*, NFIB Research Foundation, 2012. www.nfib.com/research-foundation/surveys/credit-study-2012. The Federal Reserve's *Survey of Consumer Finances* estimates that 78 percent of the self-employed own a primary residence. The "self-employed" as defined by the Federal Reserve's study is not the same as "employer" defined by the NFIB Research Foundation. However,

construction, though the sector is obviously not confined to home building. Other important industries, such as real estate, are associated with housing values and would also be affected.

An arbitrary cap amount was a necessary part of the mortgage interest question in order to provide respondents living in high-cost and low-cost areas of the country a common understanding of the amount of tax preference that could be lost and to differentiate the proposal from the cap in existing law. The amount of the cap may have been as important to respondents as the cap itself. The result is that broader issue has two parts – principle and cap size.

Table 2
Tax Preferences Eliminated or Capped in Exchange for an Equivalent Amount in Lower Rates

Tax Preference	Strongly Favor	Favor	Uncertain/ Insuff. Info.	Oppose	Strongly Oppose	Net Favor/ (Oppose)
(E) Municipal Bonds	15.2%	32.3%	20.0%	21.5%	8.2%	18.0%
(E) State/Local Taxes	7.3	20.8	15.2	34.3	20.1	(26.3)
(C) Health Insurance Exclusion	17.5	39.1	19.5	15.6	6.2	34.8
(C) Total Deductions	12.4	32.9	23.9	18.6	9.1	17.6
(E) Production Tax Credit	27.6	35.7	17.4	12.7	4.3	46.3
(C) Mortgage Interest *Primary Residence*	30.6	42.0	7.0	11.8	6.5	54.3
(E) Mortgage Interest *Second Residence*	27.7	35.5	8.1	19.4	7.5	36.3
(E) Interest *Home Equity Loans*	15.8	26.6	11.9	31.8	10.9	(0.3)

(E) – eliminate
(C) – cap

The principle of capping the home mortgage deduction proved more influential than the cap's size. Still, the cap's size lay behind the view of many respondents. Fifty-seven (57) percent of those who favored the $500,000 cap on the deduction claim they did so on principle; 35 percent did so because of the cap's size. Six percent offered no opinion and the remainder were undecided. Similar proportions held for those who opposed capping the deduction at $500,000. Fifty-four (54) percent of that group claimed principle and 28 percent cap size. In total, 58 percent of those expressing a view say theirs was based on principle and 32 percent on cap size. Presumably, those influenced by cap size might have their views changed should the cap size be altered. No data were collected that would help estimate the direction and/or the amount of change to the cap necessary for respondents to reconsider their views.

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both show that a disproportionately large share own a primary residence. See, Jesse Bricker, Arthur B. Kennickell, Kevin B.Moore, and John Sabelhaus, Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances, *Federal Reserve Bulletin*, Vol. 98, No. 2, June, 2012. www.federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf.

The size of mortgage debt outstanding could help determine where the cap size might become a sensitive subject for many respondents. NFIB members are somewhat older than the population of small-business owners and tend also to be somewhat more rural. It is therefore likely that mortgage debt outstanding is somewhat lower for NFIB members than it is across the broader population. Still, the mortgage debt owed by small-business owners is typically not large. The survey asked respondents to estimate the amount of outstanding debt on their home mortgage including first mortgages, second mortgages, and home equity loans. Forty-one (41) percent have no mortgage debt. Seven percent have less than $50,000 outstanding; 11 percent between $50,000 and $99,999; 19 percent between $100,000 and $249,999; 12 percent between $250,000 and $499,999; and, 3 percent $500,000 or more. Thus, it appears that very few owners would be immediately affected as taxpayers. The primary impact would come on construction firms (and related industries, such as real estate sales) building and selling homes where very large mortgages are common.

Industry unexpectedly is not associated with views on the potential exchange. NFIB members in construction and the financial services express no more or less enthusiasm for the trade of a $500,000 cap on the mortgage interest deduction for lower rates than those owning businesses in other industries. Nor does the cap seem to play an extraordinary role. The size of the cap exhibits no more influence among those in the construction industry than others. The author has absolutely no explanation for the result.

A related issue is the tax preference for mortgage interest on a second residence. The survey question posed the elimination of the deduction in exchange for the equivalent amount in lower rates. A net 36 percent approve (63% favor vs. 27% oppose) of the trade. Data from outside this survey indicates that 22 percent of small employers own a second residence (including a time share), though the number holding a mortgage on that property is not known.[8] That number is reasonably similar to the 27 percent opposing elimination, suggesting a measure of self-interest.

NFIB members in the construction industry are less likely to favor the elimination of the interest deduction on second residences than those in other industries. The net difference among the former is 25 percent and among the latter is 37 percent. A majority in construction favor the proposal (53%); 38 percent oppose it. The response difference between capping interest on first residence and eliminating interest on second residences suggests that the size of the cap plays a more important role than acknowledged. Still, the favorable majorities from the construction industry remain curious.[9]

The exception to the general support given to an exchange of the mortgage interest preference for lower rates is interest on home equity loans. The number favoring and opposing the proposal are almost identical, 42 percent favor and 43 percent oppose. The likely reason for the break in pattern on the interest deduction is the number who use (or have used) home equity loans to support their businesses. In 2011, 22 percent of small employers used loans backed by real estate to directly or indirectly finance their business.[10] Interest accrued on loans for business purposes is deductible, whether as a direct business loan or as a home equity loan used for business purposes. Apparently, NFIB members fear that the elimination of the mortgage interest deduction on home equity loans will result in the loss of a frequently used source of credit for business purposes. While that is not necessarily true given that interest on loans used for business purposes is a deductible business expense under most conditions, it is the most plausible explanation for the enormous difference in its outcome compared to the other two mortgage interest deduction questions.

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[8] *Small Business, Credit Access, and a Lingering Recession*, op. cit.

[9] Possible explanations for contractor views include: most contractors work on homes far under the proposed limit and second homes are typically smaller and purchased with a greater percentage of cash.

[10] *Small Business, Credit Access, and a Lingering Recession*, op. cit.

b. State and Local Tax Deduction

NFIB members all pay state and local taxes and often in large amounts. It does not surprise therefore that a net 26 percent oppose eliminating the deduction for state and local taxes. However, deductibility of state and local taxes is considerably more beneficial to small-business owners in high-tax states than in low-tax states for the obvious reasons. That implies one should expect NFIB members in high-tax states to be less supportive of retaining the deduction than those in low tax states.

The Tax Foundation produces a state business tax climate ranking.[11] The author divided the states' rankings into three groups: the 15 states with the most positive rankings; the 20 states with middling rankings; and the 15 states with the most negative rankings. No relationship exists between these rankings and NFIB member desires to trade an elimination of the state and local tax deduction for an equivalent amount in lower rates. If anything, NFIB members of the middling group were least likely to oppose the proposal. Changing the measure of taxes paid to the Tax Foundation's Tax Freedom Day[12] changes the results somewhat. The change shows those in states with the earliest Tax Freedom Days (lowest taxes) are more likely to favor a trade than those in latest Tax Freedom Days (highest taxes). Still, the former oppose it by a 31 percent (for) to 50 percent (against) margin contrasted to the latter's 23 percent (for) and 59 percent (against). The middling group is in the middle.

The AMT does not allow deductions for state and local taxes paid. Even though the state and local taxes paid deduction for the AMT is not the same issue as the deduction on a regular IRS Form 1040, one suspects that those who paid the AMT in their last tax year may be more sensitive to retaining the deduction than others. That is modestly true for those who actually paid the AMT (an 8 percentage point difference), but not for those who simply had it calculated. The upshot is that the status of state and local taxes for the AMT exerts minimal influence over NFIB member views on the deduction more generally.

c. Exclusion of Employer-Provided Health Insurance

Employees can exclude (not count) from income the amount their employer pays for health insurance; employers can deduct their contribution as a business expense. Small-business owners have generally opposed change in the employer-provided health insurance exclusion, though the relevant questions of which the author is aware have not capped the exclusion AND carried a proviso that the revenues generated would be returned in the form of lower rates. Here, for investigative purposes, the exclusion is capped at $5,000 and the revenue neutral proviso included. Under these circumstances, a net 35 percent favor capping the exclusion. Still, just a small majority (57%) supports the trade.

The principle versus the amount issue arises again at this point. And, again the principle appears to be the driving force behind the views held. Fifty-eight (58) percent of those favoring a $5,000 cap on the exclusion report their view is based on principle compared to 23 percent who say that it is the exclusion's size. A hefty 19 percent have no opinion or did not answer. In contrast, 53 percent of those opposed say principle is the reason for their views, while 34 percent of the group say their opposition is primarily influenced by the size of the exclusion. Given prior expressions of views, the lion's share of those influenced by the exclusion's size probably think it is too low. Thus, it is possible that 7 - 8 percent of the population could change their minds toward approval if the exclusion were raised to, say, $7,500. That would raise the total favoring the trade to about two-thirds.

The Patient Protection and Affordable Care Act (PPACA) requires employers to offer employees health insurance if they have 50 or more full-time or full-time equivalent people working for them (83

[11] http://taxfoundation.org/article/2013-state-business-tax-climate-index.

[12] http://taxfoundation.org/article/tax-freedom-day-state-2012

respondents). In addition, eleven percent of respondents employ no one other than themselves and/or other owners; they provide health insurance only for themselves and their families (if at all). Larger, small employers ensnared by PPACA produce virtually the same totals on the capped exclusion as does the remainder of survey respondents. Those without employees offer somewhat less support for the proposal. But that appears offset by the larger proportion of the group that is uncertain or lacks sufficient information to make a determination.

d. Cap on Total Deductions

A recently discussed proposal is to cap the total amount of deductions any taxpayer can take in exchange for lower rates. Politically attractive because it allows legislators to avoid the relative merits (or lack of) for popular preferences and their potent supporters, the idea is to consolidate all deductions, set a cap, and disallow any deductions above that cap regardless of their purpose. The cap could be a percentage of adjusted gross income as used in the question presented to respondents of this survey or it could be a flat number.[13]

NFIB members support the proposal, though it garnered only a net 17 percent favorable rating. Just 45 percent offer a favorable verdict and only 12 percent favor it strongly. One significant caveat is the 24 percent who are uncertain or who have insufficient information to express an opinion. This one-quarter of the population appears open to persuasion, one way or the other.

The amount of the cap was arbitrarily set for the survey question at 15 percent of AGI (adjusted gross income). But the concept appears to be the attractive feature for many who favor it. Two-thirds (67%) say they support the proposal because of the principle while 18 percent of supporters find the cap's size attractive. (The cap is lower than found in many proposals, likely influencing the totals more than in other similar questions.) Those opposed selected the cap relatively more often for their views. Still, 58 percent indicated their negative views were primarily based on principle while 30 percent selected cap size for theirs.

e. Other Preferences

The production tax credit results (net 46 percent favor elimination) can likely be explained by the numerous and very public scandals involving government loan guarantees to various producers of environmentally-friendly energy. While different than the production credit, the negative publicity generated for government subsidies to the industry and the narrow use of the credit earns it an overwhelming thumbs-down from NFIB members. The survey question still carries the proviso that the revenues gained from its elimination are returned in the form of lower tax rates.

The last item on the list of preferences is tax-free municipal bonds. NFIB members on balance would eliminate tax-free municipal bonds, but the margin is only a net 18 percent. The modest margin begs the question why people who are likely to earn relatively little from such bonds are not more willing to eliminate them. The most plausible explanation is that small-business owners are active in their communities. They take indirect advantage of these federal subsidies through public works and local development projects. The community's interest in this case becomes transcendent.

[13] The potential similarities between this proposal and the AMT should not be missed.

f. Capital Gains and Dividends

NFIB members do not consider capital gains or dividends in the same general category as other tax preferences.[14] Part of the explanation could lie in the manner the questions were asked. Questions about other popular tax preferences were posed in terms of all revenues being returned in the form of lower tax rates. The questions on capital gains and dividends were posed without it. Further, the question about dividends told the respondent to assume that double-taxation of corporate income had been eliminated. Still, NFIB members think that both should receive tax preferred treatment, particularly capital gains.

Nineteen (19) percent think capital gains should be treated as ordinary income, 9 percent strongly. Seventy (70) percent disagree, 52 percent strongly. The latter think they should be tax-preferred, though the amount of the preference was not part of the question. They could think that the current treatment is too generous, insufficiently generous, or about right.

NFIB member opinion regarding dividends is less stark. While 53 percent think that dividends should receive favorable tax treatment, 34 percent think they should be treated as ordinary income. Further, the strength of views held is notably less. One might surmise that owners of C-corporations think differently than their colleagues given the double taxation of corporate dividends. However, their views are similar, with 5 percentage points more thinking dividends should be preferred, with no difference in the number thinking they should be treated as ordinary income. The likely explanation for the similar views of owners of C-corporations and pass-through entities is the same. The double taxation problem is often handled in small, closely-held C-corporations by zeroing out profits (subject to certain IRS rules), thereby not needing to pay the additional levy. Supporting that rationale is the fact that they typically earn relatively little in dividend income elsewhere and much of it is appears to be held in tax preferred pension accounts.

Tax Preparation

Small-business owners rarely prepare their own taxes. A professional prepared last year's tax return for 91 percent of NFIB members; 81 percent had them prepared exclusively by a professional and another 10 percent used both a software package and a professional. Five percent used a software package exclusively and 2 percent used neither a professional tax preparer nor a software package. Two percent did not respond.

All subsets of the small-business owner population overwhelmingly use a tax professional. The owners most likely to still prepare their own tax returns are the very smallest, non-employing proprietors. For example, 75 percent of those grossing less than $100,000 prepared theirs with professional help in the last tax year; that rose to 88 percent among those annually grossing between $100,000 and $249,999; the figure reaches 94 percent of those annually grossing between $250,000 and $499,999; etc.

The almost universal employment of tax professionals by small-business owners raises at least two critical issues for public policy. The first is cost, about which much has been written. Tax professionals are expensive. Small business owners spend on average $74.24 per hour (2003 data) on the paperwork associated with tax compliance, the most costly type of paperwork small business

[14] Dividends may or may not be tax preferred, depending on one's view. They can be tax disadvantaged due to their double-taxation (once at the corporate level and again at the personal level). If considered double-taxation, their tax status (advantage or disadvantage) depends on the rate at each point they are taxed. If one considers only the personal rate, they are tax preferred.

experiences.[15] Small-business owners must absorb these fees as a cost of doing business as well as the expenses for internal tax administration (record-keeping) they otherwise would not incur.

The second issue is less noticed, but equally important for policymakers. The heavy use of tax professionals questions the value of many tax incentives. If small-business owners must consult tax professionals, they clearly lack familiarity with tax law. That lack of familiarity includes tax incentives designed to promote "desirable" economic and/or social behavior. Should owners be totally unaware of the incentive, as, for example, most were of the tax credit in the Patient Protection and Affordable Care Act designed to encourage small-business owners to purchase health insurance for their employees,[16] then it provides no motivation to take the desired action. A tax professional may subsequently claim the tax benefit for a client, but it is merely a wind-fall; it has no incentive effect. Even if the owner has passing knowledge of an incentive, it likely has a muted impact. The owner still must consult his tax professional (for a fee) to determine the benefit amount before factoring it into his business decision. The more recent the incentive, the more frequent the change in terms of the incentive (or even its existence), the more complicated the incentive, the less likely the incentive will have the desired effect. Thus, the employment of tax professionals is the simply an expensive "canary in the coal mine;" it warns policy-makers that the code is too complex.

The Federal Budget and Its Problems

The nation must tackle its long-term fiscal imbalance. Action to achieve that objective implies a division between spending cuts and revenues raised. The split between the two is a major point of contention at this writing. However, the direction NFIB members prefer is clear. They want spending cuts and to a much lesser degree will take some revenue increases in terms of additional taxes to get them.

A plurality (36%) wants to reduce the federal budget deficit through spending cuts *only*. In other words, 100 percent of the reduction should come from the spending side. These are not outliers. The next largest group (27%) wants the division to approximate a 90 – 10 split, 90 percent spending cuts and 10 percent tax increases. The third largest group (18%) prefers a 75 – 25 split. Eighty-one (81) percent, therefore, want a spending cut to tax increase ratio of at least 3 to 1, with the emphasis on cuts. The majority of the remaining 19 percent either was uncertain (7%) or did not answer (3%). Eight percent preferred a 50 – 50 split. Virtually no one favors more tax increases than spending cuts, or neither tax increases nor spending cuts.

All parties agree that economic growth increases public revenues. However, some tax increases/reductions generate more/fewer revenues in the long-run than others. In other words, the way revenues are raised/reduced matter, though the precise amount of revenue raised by each proposed measure is the subject of heated debate. Further, increased government spending intended to generate greater demand thereby adding revenue is a matter also subject to serious dispute. That leaves the question: what is the best fiscal policy(ies) to encourage more rapid growth.

NFIB members selected the best growth strategy to close the budget deficit from among the following choices: spending cuts alone, spending cuts and tax increases, tax increases alone, changing

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[15] *Paperwork and Record Keeping – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 3; Issue 5; 2003.

[16] See, *Small Business and Health Insurance: One Year After Enactment of PPACA*, May, 2010, http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/ppaca/NFIB-healthcare-study-201107.pdf. Forty-eight (48) percent of the small employer population (fewer than 50 employees) had heard of the credit of which 23 percent thought they were eligible. Of that 11 percent of the population, a significant percentage of those who thought they were eligible were not. Similarly, a notable share of those who had not heard of the credit proved eligible.

the tax code to provide fewer tax preferences and lower tax rates, and increased spending (priming the pump). Fifty-three (53) percent chose changes to the tax code providing lower rates and fewer preferences. The second most common choice was spending cuts alone (25%). The third was a combination of spending cuts and tax increases (16%). Just 1 percent thinks priming the pump will do the job and less than one-half of one percent think tax increases alone are the appropriate course of action.

Alternative Tax Systems

Questions have been raised for a long time about the possibility of adding a major alternative type of tax system at the federal level. The motivation behind the proposals typically has been to raise more revenue. But in the case of the carbon tax, proponents have argued for the tax as a means to reduce consumption of carbon-based energy by adding a tax and raising its price. The VAT, on the other hand, has also been proposed as a minimally distorting consumption tax that is highly efficient and difficult to evade. NFIB members have a passing familiarity with both and are not particularly sympathetic with either proposal.

Fourteen (14) percent of NFIB members claim to be "very familiar" with a carbon tax. Another 48 percent are "somewhat familiar" with it; 36 percent say they are not familiar with the idea. The survey then asked those who either were "very" or "somewhat" familiar with the carbon tax whether in the future they favored or opposed implementing it to reduce or replace another tax in whole or in part. Revenue neutrality was implicit to the question. Even then, the NFIB member verdict is negative. Eleven (11) percent favor introduction of a carbon tax in lieu of another tax, in whole or in part, while 67 percent oppose it. Fourteen (14) percent say they are uncertain or do not have enough information.

But suppose a carbon tax were introduced. What should be done with the new revenues generated? Forty-two (42) percent indicate that they think that the new revenues should be used both to offset other taxes *and* to reduce the deficit; 36 percent identify reducing the deficit as the desired use for the money; and 10 percent say the additional revenue should be used to offset other taxes only. The majority, therefore, do not appear adverse to some new money, should it be available, directed to deficit reduction. On one point, they are absolutely clear: just four-tenths of one percent (0.4%) want new revenues spent on "priorities".

The second alternative tax system assessed was the VAT. A larger proportion claimed at least some familiarity with the VAT than with the carbon tax, likely because it has been in the policy conversation longer and the tax is common throughout the developed world. Still, only 23 percent claim to be "very familiar" with a VAT while 49 percent claim to be "somewhat familiar" with it. Twenty-four (24) percent say they are not familiar with the tax. Those in construction, agriculture, and to a lesser extent, services were somewhat less familiar with the VAT than those in other industries.

The VAT fares better than a carbon tax in the judgment of NFIB members, but not well overall. Seventeen (17) percent of those familiar with a VAT say that they favor introducing it at some point in the future to reduce or replace another tax in whole or in part. That is 6 percentage points more than favoring the carbon tax. Yet, 58 percent oppose introduction of a VAT and 19 percent are undecided or have insufficient information.

Suppose a VAT were introduced this time instead of a carbon tax. What should be done with the new revenues? Forty-three (43) percent say that they think that the revenues should be used both to offset other taxes *and* to reduce the deficit; 29 percent would reduce the deficit; and 16 percent say the additional revenue should be used to offset other taxes only. Seventy-two (72) percent would use at least some of the money to reduce the deficit. Spending the money is again out of the question. Just five-tenths of one percent (0.5%) would spend it on "priorities".

Little difference in small-business owner views of either the carbon tax or the VAT appeared. The exception was modestly higher opposition to the carbon tax among those in the transportation and warehousing industry.

Bottom Line

Agree or disagree? My single greatest priority in any fundamental restructuring of the tax law is whether my total tax bill will rise or fall. That seems to be the ultimate question for many NFIB members and they answer it emphatically. Their tax bill is the ultimate test of tax change. Seventy (70) percent agree that their taxes rising or falling is the bottom line; 20 percent disagree, with the remainder not having an opinion (8%) or not answering (0.5%). Differing from many questions in the survey, the results here are not as polarized. The 71 percent agreeing divided into 33 percent strongly agreeing and 38 percent simply agreeing. The 20 percent divided between 3 percent strongly disagreeing and 17 percent agreeing. This result suggests that the primary driver for NFIB members in tax restructuring is whether their total tax bill rises or falls.

The survey highlights the challenges inherent to fundamental tax restructuring. NFIB members are open to growth-promoting changes in the tax code, including a reduction or elimination of some preferences in exchange for lower rates. The caveat is that flattening the base be accompanied by a revenue neutral tax bill and retention of some small-business specific preferences, such as expensing. While NFIB members strongly prefer a tax code with lower rates and fewer preferences, and are willing to eliminate or cap some preferences to achieve lower rates, it can be concluded that they assume that a revised tax code will result in taxes that are on net no higher than they are today.

NFIB members may even hesitantly accept some new revenues in a long-term budget agreement, so long as spending cuts are significantly larger. But, those new revenues would have to be directed to reducing the debt, not continued increases to government spending. The implication is that NFIB members support change in the abstract, but the actual effects on their overall tax liability and compliance costs are critically important.

Methodology

This survey was conducted across a random sample of 12,500 NFIB members between mid-November and mid-December, 2012. The survey was conducted by mail, with an initial mailing and two follow-ups. One thousand two hundred and eighteen (1,218) responded and 1,198 were usable for a 9 percent response rate.

A brief demographic profile of respondents appears at the end of the survey instrument, principally in questions 22 through question 25.

FEDERAL INCOME TAXES

Mark the appropriate answer(s).

1. Fundamental change in the federal tax code should occur within the next year.

1. Strongly agree	54.9%
2. Agree	30.0
3. No opinion	3.3
4. Disagree	3.1
5. Strongly Disagree	2.6
N/A	6.2

2. Which TWO from the list below have the *highest* priority in any fundamental tax change? (Mark TWO only. More than TWO marked answers cannot be counted.)

a. Repeal of the AMT (Alternative Minimum Tax)		19.4%
b. Repeal of the estate and gift tax		45.1
c. Reduced marginal income tax rates		11.4
d. Allow full expensing of business equipment AND real property		25.0
e. Eliminate the double tax on corporate dividends		12.4
f. Reduce tax complexity		51.8
g. No net tax increase		24.5
h. Other (Specify) ____________		3.2
	Fair/Flat tax	2.0
	No second choice	3.4
	N/A	1.8

3. Which TWO from the list below are the *worst* aspects of the current federal income tax system? (Mark TWO only. More than TWO marked answers cannot be counted.)

a. Constant change makes planning and compliance difficult.		41.7%
b. Rates are too progressive (too much difference between low tax brackets and high ones).		15.7
b. Deductions, deferrals, credits, and exclusions are inconsistent and distort economic decision-making.		47.5
e. Doesn't raise enough revenue to pay for government costs.		6.8
f. Tax rates are too high.		29.5
g. Complexity raises compliance costs and muddles possible tax incentives.		36.2
h. Tax considerations unnecessarily affect business decisions.		16.9
i. Other (Specify) ____________		1.8
	No second choice	2.0
	N/A	1.8

4. What is the most complex or complicated part of the federal tax code for you and your business?

1. Capital gains	8.8%
2. Depreciation	11.8
3. Pension Rules	3.8
4. Passive Income	4.3
5. Inventory Accounting	5.0
6. AMT	6.5
7. Quarterly filings	3.5
8. Other ________	2.3
9. I let my tax preparer worry about complexity	52.2
N/A	1.8

5. Do you think fundamental tax change should be part of a larger effort to bring the federal budget deficit under control, or be an independent effort to rationalize the tax code?

1. Strongly - Part of overall budget effort	42.2%
2. Part of overall budget efforts	20.1
3. No opinion	6.8
4. Independent effort	15.9
5. Strongly - Independent effort	13.5
N/A	1.4

6. Fundamental tax change will NOT result in less complexity, no matter what the intent.

1. Strongly agree	17.0%
2. Agree	38.4
3. No opinion	10.9
4. Disagree	24.2
5. Strongly Disagree	8.3
N/A	1.2

7. Regardless of any other outcome, my single greatest priority in any fundamental change in the tax laws is whether my total tax bill will rise or fall.

1. Strongly agree	32.9%
2. Agree	38.2
3. No opinion	7.7
4. Disagree	17.4
5. Strongly Disagree	3.3
N/A	0.5

Tax preferences, such as deductions, deferrals, credits, and exclusions, allow certain types of income to be taxed more advantageously (or not at all).

8. As a general rule, do you favor a federal tax code with *more* tax preferences and *higher* tax rates, OR a code with *fewer* tax preferences and *lower* tax rates?

1. More preferences and higher rates – strongly		0.8%
2. More preferences and higher rates – somewhat		1.8
3. Uncertain or not enough information		18.3
4. Fewer preferences and lower rates – somewhat		26.5
5. Fewer preferences and lower rates – strongly		51.7
	N/A	0.9

9. *In the following questions, some major tax preferences are identified. They could be reduced or eliminated in exchange for lower personal income tax rates. Changes, if made, should be phased in over time. Please indicate if you favor or oppose trading a specific tax preference for lower tax rates.*

A. Investors currently do not pay tax on interest payments from state, municipal, and development bonds. Do you favor or oppose eliminating this tax preference in exchange for lower personal income tax rates?

1. Strongly favor		15.2%
2. Favor		32.3
3. Uncertain/Insufficient information		20.0
4. Oppose		21.5
5. Strongly oppose		8.2
	N/A	2.8

B. Non-business state and local taxes (including property taxes) are deductible. Do you favor or oppose eliminating this deduction in exchange for lower personal income tax rates?

1. Strongly favor		7.3%
2. Favor		20.8
3. Uncertain/Insufficient information		15.2
4. Oppose		34.3
5. Strongly oppose		20.1
	N/A	2.3

C. Employees can now exclude (not count) from income the amount their employer pays for health insurance. Do you favor or oppose capping the exclusion at $5,000 for employees who receive employer-paid health insurance in exchange for lower personal income tax rates? (Employers could still deduct their contribution as a business expense.)

1. Strongly favor		17.5%
2. Favor		39.1
3. Uncertain/Insufficient information		19.5
4. Oppose		15.6
5. Strongly oppose		6.2
	N/A	2.1

C1. Is your view on the cap in the previous question based on the principle of capping the exclusion or the amount of the cap ($5,000)?

1. Strongly principle	15.2%
2. Principle	30.7
3. No opinion	24.7
4. The cap	17.1
5. Strongly the cap	4.6
N/A	7.7

D. Do you favor or oppose capping the total amount (all) of non-business deductions that any taxpayer can take, regardless of what those deductions are, to 15 percent of adjusted gross income in exchange for in lower personal income tax rates?

1. Strongly favor	12.4%
2. Favor	32.9
3. Uncertain/Insufficient information	23.9
4. Oppose	18.6
5. Strongly oppose	9.1
N/A	3.1

D1. Is your view on the cap based on the principle of capping total deductions or the amount of the cap (15%)?

1. Strongly principle	14.7%
2. Principle	34.1
3. No opinion	23.5
4. The cap	14.9
5. Strongly the cap	3.8
N/A	9.0

E. A tax credit, known as the "Production Tax Credit," is allowed for the production and sale of electricity from wind, biomass, geothermal, solar, and municipal solid waste. Do you favor or oppose eliminating this deduction in exchange for lower personal income tax rates?

1. Strongly favor	27.6%
2. Favor	35.7
3. Uncertain/Insufficient information	17.4
4. Oppose	12.7
5. Strongly oppose	4.3
N/A	2.3

Homeowners currently can deduct mortgage interest on homes up to $1.1 million a year. These limits apply to mortgages on a primary residence, a second (non-rental) home, and home equity loans.

F. Do you favor or oppose capping the mortgage interest deduction at $500,000 for a primary residence in exchange for lower personal income tax rates?

1. Strongly favor	30.6%
2. Favor	42.0
3. Uncertain/Insufficient information	7.1
4. Oppose	11.8
5. Strongly oppose	6.5
N/A	2.0

F1. Is your view on the cap in the previous question based on the principle of capping the deduction or the amount of the deduction's cap ($500,000)?

1. Strongly principle	20.5%
2. Principle	33.5
3. No opinion	9.6
4. The cap	23.0
5. Strongly the cap	8.5
N/A	4.8

G. Do you favor or oppose eliminating the mortgage interest deduction on SECOND residences in exchange for lower personal income tax rates?

1. Strongly favor	27.7%
2. Favor	35.5
3. Uncertain/Insufficient information	8.1
4. Oppose	19.4
5. Strongly oppose	7.5
N/A	1.8

H. Do you favor or oppose eliminating the interest deduction on home equity loans in exchange for lower personal income tax rates?

1. Strongly favor	15.8%
2. Favor	26.6
3. Uncertain/Insufficient information	11.9
4. Oppose	31.8
5. Strongly oppose	10.9
N/A	3.0

10. Should *capital gains* be treated for personal income tax purposes as ordinary income or should they be taxed at a lower rate?

1. Strongly, ordinary income	8.5%
2. Not so strongly, ordinary income	10.7
3. No opinion	8.9
4. Not so strongly, tax preferred income	17.3
5. Strongly, tax preferred income	52.3
N/A	2.3

11. Should *dividends* be treated for personal income tax purposes as ordinary income or should they be taxed at a lower rate? (Assumes that double-taxation of dividends at the corporate level is eliminated.)

1. Strongly, ordinary income	16.7%
2. Not so strongly, ordinary income	17.6
3. No opinion	11.0
4. Not so strongly, tax preferred income	12.9
5. Strongly, tax preferred income	39.6
N/A	2.2

12. If fundamental tax reform reduced tax complexity enough to lower the cost of tax preparation, would you accept a ____ percent increase in personal income taxes to compensate for your lower administrative costs.

1. No increase	63.3%
2. 1% increase	14.4
3. 2% increase	6.2
4. 5% increase	1.9
5. No opinion	11.6
N/A	2.6

The United States is currently experiencing the fourth consecutive annual federal budget deficit of more than $1 trillion dollars, forcing our total national debt to twice the amount is was in 2007. The total will continue to grow no matter what happens in the next few years. However, by seriously addressing the problem, we can start reducing the size of annual deficits and work toward a balanced annual budget. How do we reduce the deficit?

13. What should be the approximate ratio of spending cuts to tax increases?

1. 100% spending cuts/0% tax increases	36.2%
2. 90% spending cuts/10% tax increases	27.4
3. 75% spending cuts/25% tax increases	18.0
4. 50% spending cuts/50% tax increases	7.5
5. 25% spending cuts/75% tax increases	0.3
6. 10% spending cuts/90% tax increases	0.2
7. 0% spending cuts/100% tax increases	0.7
8. Uncertain/Insufficient information	7.0
N/A	2.7

14. Faster economic growth will help to reduce the size of the Federal Government's annual deficits. But what is the BEST way to achieve more rapid growth?

1. Spending cuts alone	24.5%
2. Spending cuts and tax increases	16.0
3. Tax increases alone	0.3
4. Revising the tax code, emphasizing fewer preferences and lower rates	53.3
5. Temporarily spending more ("priming the pump")	0.8
6. No opinion	3.0
N/A	2.2

15. A carbon tax, that is, a tax placed on carbon-based fuels, principally coal and oil, is a tax that potentially could reduce tax rates or replace other taxes in whole or in part. Are you familiar with the carbon tax proposal?

1. Yes, very familiar → continue		14.4%
2. Yes, somewhat familiar→ continue		45.6
3. No → Go to Q#15b		35.7
	N/A	4.3

15a. What is your view of implementing a carbon tax at some point in the future to reduce or replace another tax in whole or part?

1. Strongly favor	1.7%
2. Favor	9.0
3. Not enough information	14.1
4. Oppose	31.2
5. Strongly Opposed	44.0

15b. If a carbon tax were enacted, what should be done with revenues from it? Should they be used to:?

1. Offset other taxes only		9.9%
2. Reduce the deficit		35.8
3. Both, offset other taxes and cut the deficit		42.3
4. Spend on priorities		0.4
5. No opinion		6.3
	N/A	5.2

16. A VAT (value added tax) is a type of national sales tax that is levied at every step of the production-distribution-consumption chain. Are you familiar with the VAT?

1. Yes, very familiar → continue		22.5%
2. Yes, somewhat familiar→ continue		49.0
3. No → Go to Q#16b		24.2
	N/A	4.3

16a. What is your view of implementing a VAT at some point in the future to reduce or replace another tax in whole or part?

1. Strongly favor		7.7%
2. Favor		9.2
3. Not enough information		18.9
4. Oppose		24.4
5. Strongly Opposed		33.4
	N/A	6.3

16b. If a VAT were enacted, what should be done with revenues from it? Should they be used to:?

1. Offset other taxes only	16.2%
2. Reduce the deficit	28.8
3. Both, offset other taxes and cut the deficit	42.7
4. Spend on priorities	0.5
5. No opinion	6.3
N/A	5.5

17. Did you use a professional tax preparer, a tax software package, both, or neither to prepare your last federal income tax return?

1. Used professional tax preparer	80.6%
2. Used tax software package	5.4
3. Used both a tax professional and tax software	10.4
4. Used neither a tax professional nor tax software	2.1
N/A	1.6

18. I (my tax advisor) had to calculate the Alternative Minimum Tax (AMT) this last tax year.

1. Yes → continue	35.7%
2. No → go to Q#19	27.5
3. Don't recall → got to Q#19	30.6
N/A	6.1

18a. I had to pay the Alternative Minimum Tax (AMT) this last tax year? (Only of those calculated.)

1. Yes	47.0%
2. No	40.4
3. Don't recall	11.0
N/A	1.6

19. Please estimate the amount of depreciable business assets, including real property and their improvements, purchased in your last year.

1. <$10,000	29.5%
2. $10,000 - $49,999	23.2
3. $50,000 - $99,999	11.9
4. $100,000 - $249,999	10.9
5. $250,000 - $499,999	6.4
6. $500,000 - $999,999	3.2
7. $1 M or more	2.3
8. Can't recall	4.4
9. Prefer not to answer	5.4
N/A	2.8

20. Please estimate the amount *outstanding* on your home mortgage (first, second, and home equity, if applicable).

1. No mortgage	40.7%
2. <$50,000	6.7
3. $50,000 - $99,000	11.0
4. $100,000 - $249,000	19.0
5. $250,000 - $499,000	12.4
6. $500,000 or more	3.2
7. Can't recall	0.5
8. Prefer not to answer	4.5
N/A	1.9

21. Have you incurred any expenses in the last five years, such as in consulting a tax advisor or purchasing more life insurance than you otherwise would, in order to reduce or eliminate any potential tax liability from the estate tax?

1. Yes	34.4%
2. No, but expect to in the future	15.2
3. No	44.8
4. Do not plan to pass on the business	3.8
N/A	1.8

22. What is your legal form of business?

1. Proprietorship	18.0%
2. Partnership	3.1
3. S-Corporation	44.5
4. C-Corporation	21.2
5. Limited Liability Corp. (LLC)	11.6
N/A	1.6

23. What is the primary industry of your business?

1. Construction	12.2%
2. Manufacturing	11.4
3. Agriculture	15.4
4. Retail, Wholesale	20.1
5. Finance, Insurance, Real Estate	10.7
6. Transportation/Warehousing	2.8
7. Services	25.5
8. Other (specify) _______	1.1
N/A	0.8

24. How many employees do you have not counting the owner(s)?

1. None	11.3%
2. 1-4 employees	30.7
3. 5-9 employees	22.0
4. 10 – 14 employees	10.9
5. 15-19 employees	6.6
6. 20 – 49 employees	10.9
7. 50 – 99 employees	3.4
8. 100+ employees	3.4
N/A	0.8

25. Approximately, what were your gross sales in your last fiscal year?

1. < $100,000	7.4%
2. $100,000 - $249,999	10.3
3. $250,000 - $499,999	13.7
4. $500,000 - $999,999	15.9
5. $1m - $4.9m	29.1
6. $5m - $9.9m	7.2
7. $10m plus	6.5
8. Prefer not to answer	8.0
N/A	1.9

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Ohio Farm Bureau Federation
Testimony on the Agricultural Sales Tax Exemption
Before 2020 Tax Study Commission
Brandon Kern, Director of State Policy
February 24, 2016

Thank you members of the 2020 Tax Study Commission for the opportunity to offer testimony on Ohio's agricultural sales tax exemption. We appreciate the thoughtful review of tax expenditures this committee is undertaking. Farm Bureau shares your goal of ensuring Ohio's tax code puts our state in the most competitive position possible.

Agriculture's sales tax exemption is a critical component to creating a business environment in Ohio that allows agriculture to produce the food we all consume. The exemption is narrowly defined, and serves to uphold the objective that a sales tax is not meant to be levied on a product's input or production components.

The application of sales tax to input costs of a capital intensive, low profit industry such as agriculture would have significant and severe consequences. Farm Bureau strongly believes the sales tax exemption must be preserved.

When you look at agriculture in our state, it's easy to associate high commodity prices and increasing yields with good times for Ohio's farmers. However, as we have been reminded recently, the commodity market can be a volatile place, subject to large swings in prices. Those high commodity prices, which peaked in 2012, have tumbled since. A farmer selling corn last year, for example, on average fetched about half of what he or she did just two years prior.

This recent slide in prices is one thing, but cost of inputs for farm operations is an even bigger concern to many farmers across the state. If you don't farm, you may not think about all the input costs that farmers incur in order to produce the food we eat. But the fact is, agriculture is a highly capital intensive industry with significantly low profit margins. Those profit margins are even thinner for smaller farms. In fact, over 69 percent of U.S. farms operate in USDA's "critical zone" indicating potential financial strain. Farms operate in the critical zone if operating profits comprise less than 10 percent of the farm's gross cash farm income (GCFI). I have attached an explanation of GCFI and USDA's analysis to our testimony.

High production costs are a major driver of narrow profit margins in agriculture. To demonstrate how application of the sales tax to input cost would impact production, we have provide the model below. These statistics are based on statewide average costs compiled by The Ohio State University's Department of Agriculture, Environmental and Development Economics. They are based on 2000 acres of corn production. As you will see, for every 1,000 acres of corn produced, application of the sales tax equates to nearly $28,000 of additional cost to the farmer.

Variable Costs			Per Acre Cost	7.25% Sales Tax Per Acre
Seed (kernels)3			$116.88	$8.47
Fertilizer	Starter Fertilizer		$0.00	$0.00
	N (lbs.)		$93.89	$6.81
	P2O5(lbs)		$37.36	$2.71
	K2O(lbs)		$18.51	$1.34
	Lime(ton)		$6.25	$0.45
Chemicals		Herbicide	$55.93	$4.05
		Fungicide	$0.00	$0.00
		Insecticide	$0.00	$0.00
Drying (Fuel & Electric)			$36.75	$0.00
Trucking - Fuel Only			$3.74	$0.00
Fuel, Oil, Grease			$17.26	$1.25
Repairs			$26.78	$1.94
Crop Insurance			$21.00	$0.00
Miscellaneous			$12.00	$0.87
Int. on Oper. Cap.			$9.47	$0.00
Hired Labor			$0.00	$0.00
Total Per Acre			**$455.81**	**$27.90**

Machinery	Cost
37 ft. Chisel Plow	$50,500
60 ft. Field Cultivator	$75,500
Boom Sprayer, Self Prop.	$242,500
16 Row Planter	$105,500
Combine 440 HP	$360,000
Corn Head 8 Row	$59,000
Anhydrous Applic. 32.5'	$21,000
Fertilizer Spreader	$12,000
2 Semi Tractor/Trailers**	$70,000
Grain Cart	$50,500
360 HP Tractor	$274,000
310 HP Tractor	$266,000
Total	**$1,586,500**
7.25% Sales Tax	**$115,021.25**
Annual Additional Sale Tax Cost (8 Year Depreciation)	**$14,377.66**

Across Ohio, Farm Bureau members host "Farmers' Share" Breakfasts, charging only $1 for made to order omelets, pancakes, sausage and choice of drinks. This community service event allows the public to interact with farmers while enjoying a breakfast costing about what farmers receive for the meat, eggs, cheese, grain and milk that go into each breakfast. We do this to demonstrate how little the cost of food is attributable to those who grow it. To demonstrate this further I have also provides a Report Summary from the Economic Research Service at USDA, which examines what accounts for the cost of food.

While I would like to tell you applying the sales tax to agricultural inputs would be passed on to consumers in the form of higher food costs, I can't use that scare tactic. We can't play that card because it simply isn't true -at least not immediately. For farmers, the reality is even more damaging. Because prices are dictated by commodity exchanges and global demand, increased costs associated with applying sales tax to inputs will largely be eaten by farmers. Considering the profit margins we operate on, one can't help to think this would very likely drive some farms out of business.

Getting food from field to fork requires growers, commodity handlers, food producers and logistics to connect all of those processes. Another important merit of the exemption is that it ensures compliance with the intent of the sales tax, which is to tax consumption. If you think about all the stops that food makes on its way through the production process, the impact of compounding tax is also a real concern.

Finally, the exemption is narrowly defined, is very difficult to abuse as implemented and meets the legislative intent under which it was created. It is structured so that the only items purchased are those for use in the production of agricultural goods. The use of this exemption is strictly enforced. Farmers must provide a properly completed exemption certificate to their vendor and the vendor must retain the certificate as proof of the nontaxable sale. It is the obligation of the farmer to prove the purchases are being used directly in the production of a product for sale. Items that are exempt include seeds, fertilizers, pesticides, field tiles, tractors, plows and combines. The exemption does not include almost all motor vehicles licensed to operate on the highway, lawn mowers and items used to maintain fields not in production.

The sales tax exemption is a vitally important component of Ohio's current tax code. It provides guards against compounding tax on food production and recognizes input costs for farms are not end consumption. It is prescriptive, and Ohio regulations provide appropriate levels of accountability to prevent abuse. Farm Bureau urges the committee and the legislature to recognize these benefits and preserve Ohio's agricultural sales tax exemption.

Thank you again for the opportunity to appear before the committee. I would be happy to answer any questions from committee members.

USDA

Economic Research Service

United States Department of Agriculture

Profit Margin Increases With Farm Size

by Robert Hoppe

Given the broad USDA definition of a farm, most U.S. farms are not profitable as ongoing businesses. One commonly used measure of profitability is the farm's operating profit margin (OPM), the ratio of operating profit to gross farm income. Operating profit measures funds available to finance the farm's ongoing operation after deducting the estimated market value of the unpaid labor and management services provided by the farm household. A farm is considered to be in the "critical zone," indicating potential financial problems, if operating profits comprise less than 10 percent of the farm's gross cash farm income (GCFI) from the sale of commodities and other farm-related goods and services, together with Government payments.

While 69 percent of all U.S. farms were in the OPM critical zone in 2013, 87 percent of these farms have GCFI of less than $100,000. Low profitability for smaller farms is not a recent development. For example, 15 years earlier, in 1998, 69 percent of farms were also in in the critical zone, four-fifths of which had GCFI less than $100,000 (measured in constant dollars).

Larger farms are more likely to be profitable than small farms (those with GCFI of less than $350,000), reflecting economies of size in farming. Smaller farms in the critical zone typically do not earn enough from the sale of farm commodities and ancillary services to cover expenses: cash expenses exceed cash receipts for the 70 percent of the farms with GCFI below $100,000 that are in the critical zone. The share of farms in the critical zone is especially high for retirement, off-farm occupation, and low-sales small farms—which together account for 98 percent of farms with GCFI less than $100,000—but tapers off rapidly for larger farms.

A relatively high percentage of nonfamily farms are also in the critical zone, reflecting the small size of most nonfamily farms (two-thirds have GCFI less than $100,000). An example of a small nonfamily farm would be a farm with GCFI less than $350,000 owned equally by two unrelated partners. Most nonfamily farms are not large corporations. Seventeen percent of nonfamily farms are organized as corporations, and only 8 percent of these farm corporations have GCFI greater than $5,000,000.

Given the high share of small farms in the critical zone, how do so many small farms continue to exist? Many operators stay in business by undervaluing their labor, effectively ignoring the implicit value of the unpaid labor and management they provide. Such small-farm households typically receive substantial off-farm income and do not rely primarily on their farms for their livelihood. They often use off-farm income to cover farm expenses and make investments in their farm operations.

Nevertheless, not all small farms are unprofitable. For example, 14 to 33 percent of each small-farm type has an operating profit margin of at least 20 percent. Even greater shares of larger family farms have a profit margin that high: 46 to 64 percent of midsize (GCFI of $350,000 to $999,999), large ($1,000,000 to $4,999,999), and very large ($5,000,000 or more) family farms.

Farms by operating profit margin and the farm typology, 2013

Farm typology group	Farm size, measured by annual GCFI[2]	Operating profit margin[1]: Less than 10% (critical zone)	10% to 19.999%	20% or more
		Percent of farms in the group		
All farms	Not applicable	69.3	4.7	20.4
Small family farms:	Less than $350,000			
Retirement	Less than $350,000	64.1	4.4	22.7
Off-farm occupation	Less than $350,000	75.4	2.9	13.9
Farming-occupation:				
Low-sales	Less than $150,000	76.2	3.6	16.0
Moderate sales	$150,000 to $349,999	55.8	11.5	32.5
Midsize family farms	$350,000-$999,999	41.6	12.6	45.8
Large-scale family farms:	$1,000,000 or more			
Large	$1,000,000 - $4,999,999	28.4	13.1	58.5
Very large	$5,000,000 or more	24.6	11.5	63.9
Nonfamily farms:[3]	Not applicable	59.1	5.1	33.8

Note: The farm typology focuses on family farms, where the majority of the farm business is owned by the operator and relatives of the operator. Family farms are sorted into more homogenous groups based on farm size—measured by gross cash farm income (GCFI)—and occupation of the operator, with retirement counted as an occupation.

[1]Operating profit margin (OPM) = 100% X (net farm income + interest paid - charge for operator and unpaid labor - charge for management) / gross farm income. OPM is based on both cash and noncash items. The ratio was not calculated for the 5.7 percent of farms where the denominator— gross farm income—was 0 or negative.

[2]Gross cash farm income (GCFI) is the sum of the farm's crop and livestock sales, Government payments, and other farm-related income. It includes only cash income.

[3]Farms where the majority of the business is not owned by the operator and relatives of the operator.

Source: USDA, National Agricultural Statistics Service and Economic Research Service, 2013 Agricultural Resource Management Survey.

ERS Report Summary

Economic Research Service | February 2011 | U.S. Department of Agriculture

This is a summary of an ERS report.

Find the full report at *www.ers.usda.gov/publications/err114*

A Revised and Expanded Food Dollar Series
A Better Understanding of Our Food Costs

Patrick Canning

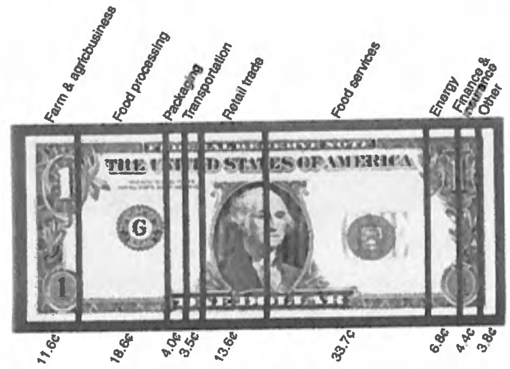
For many years, USDA's Economic Research Service (ERS) has analyzed annual spending by U.S. consumers on domestically produced food. ERS has published findings from this analysis in a series known as the marketing bill, which identified the costs of marketing the raw farm commodities contained in a typical dollar's worth of U.S.-produced food and the share of the typical food dollar going to farmers. Measurement problems, the discontinuation of several underlying data sources, and increased interest in evolving supply chain relationships prompted ERS to replace the old marketing bill series with a new expanded data series. This new series, named the food dollar series, provides a more detailed answer to the question, "For what do our food dollars pay?"

The New Food Dollar Series

The new food dollar series is composed of three primary series, each of which provides a different way of slicing the same food dollar to provide a variety of perspectives:

- The *marketing bill series*, like the previous series of that name, identifies the distribution of the food dollar between farm and marketing shares.
    - This series indicates that the costs of marketing farm commodities to U.S. food consumers were an average of 4 cents higher per consumer food dollar than was previously reported between 1993 and 2006. In 2008, the farm share was almost 16 percent.
- The *industry group series* identifies the value added from 10 distinct food supply chain industry groups to the food dollar (that is, the marginal contribution of each industry group to the final food product).
    - The farm and agribusiness share in this series differs from the farm share in the current marketing bill series (and the old marketing bill) in that it does not include nonfarm value added. In 2008, 4.2 cents of the 15.8-cent farm share was value added from nonfarm supply chain industry groups, such as energy, transportation, and financial services.
    - This series indicates that payments from each food dollar going to the energy industry group approached 7 cents in 2008, an increase of 75 percent since 1998. These estimates are higher than those provided by the old marketing bill series, which only measured direct energy use of food processors, retailers, and foodservice establishments.
- The *primary factor series* identifies the distribution of the food dollar in terms of U.S. worker salaries and benefits, rents to food industry property owners, taxes, and imports.
    - This series indicates that U.S. worker salaries and benefits coming from each food dollar steadily declined from 55 cents to 51 cents between 2001 and 2008.
    - Imported ingredients, both food and nonfood, accounted for a growing share of the food dollar, climbing from less than 5 cents in 1993 to nearly 8 cents in 2008.

2008 Marketing bill series



2008 Industry group series

2008 Primary factor series

To provide even more information about food supply chains, each of the three primary series is disaggregated into food-at-home and food-away-from-home series and into total food expenditures that do not include soft drinks and alcoholic beverages and total food expenditures that include them. Interestingly, in the food-at-home marketing bill series, the farm share of the food dollar remained around 24 cents from 1993 to 2008, suggesting that increasing expenditures on food services are behind much of the reduction in the farm share in the total marketing bill series.

In total, the new food dollar series includes 36 individual series, created by permutations of the three component series (marketing bill, industry group, primary factor), with the two commodity groupings (food/food and beverage), the three expenditure categories (total, food at home, food away from home), and the two dollar denominations (nominal, real). The series spans the period from 1993 to 2008 and will be updated annually.

How and Why Was the New Food Dollar Series Constructed?

Annual input-output (IO) data for the years 1993 to 2008, published by the Bureau of Labor Statistics, data from the 1997 and 2002 detailed U.S. benchmark IO accounts, and annual IO data for the years 1998 to 2008, published by the Bureau of Economic Analysis (BEA), were compiled and reconciled to produce annual food marketing bill estimates for the period 1993-2008, using conventional IO analysis. Supply chain IO analysis determines where food dollars wind up (as income) by tracing the market value-added measures for 10 supply chain industry groups and three primary production factors (labor, domestic industry assets, and imports). All estimates were reported in both nominal (current price) and real (inflation-adjusted) dollars.

This new approach to assessing what our food dollars pay for is superior to the former approach in several important ways:

- The quality, timeliness, and completeness of the new source data ensures that a complete accounting of the entire food system is derived from a single consolidated data source.
- A precise approach to measuring and reporting the cost components of the entire food dollar in the new series avoids the potentially confusing divisions of the previous marketing bill series.
- The new food dollar series provides a more complete accounting of the modern global food system.

February 24, 2016

Representative Jeff McClain
Co-Chairman
2020 Tax Policy Commission
Ohio Statehouse
Columbus, Ohio 43215

Senator Bob Peterson
Co-Chairman
2020 Tax Policy Commission
Ohio Statehouse
Columbus, Ohio 43215

Representative McClain, Senator Peterson, and members of the 2020 Tax Policy Commission—

On behalf of the members of the Ohio Aviation Association, thank you for the opportunity to offer testimony regarding Ohio's current tax climate and structure and its impact on the aerospace and aviation industry in our state. As the leading voice for Ohio's airports, we appreciate your attention to this subject and your efforts to keep our state competitive.

Ohio's history and significance in aviation has been well documented and it is something we all take pride in. I am happy to report that aviation and aerospace remain major economic drivers of our state's economy. These industries support more than 123,000 jobs in Ohio and generate more than $13 billion in annual economic activity. Aerospace and aviation are targeted industries for JobsOhio and we have had several economic and job creation wins in recent years.

As you know, there are a handful of tax expenditures that have been enacted since 2003 that have had a significant impact on Ohio's aviation and aerospace sector. They are as follows—

- **R.C. 5739.025(G)(1)** With respect to a sale of a fractional ownership program aircraft used primarily in a fractional aircraft ownership program, including all accessories attached to such aircraft, the tax shall be calculated pursuant to divisions (A) to (E) of this section, provided that the tax commissioner shall modify those calculations so that the maximum tax on each program aircraft is eight hundred dollars. In the case of a sale of a fractional interest that is less than one hundred per cent of the program aircraft, the tax charged on the transaction shall be eight hundred dollars multiplied by a fraction, the numerator of which is the percentage of ownership or possession in the aircraft being purchased in the transaction, and the denominator of which is one hundred per cent. *(Enacted 2003)*

- **R.C. 5739.02(B)(44)** Sales of replacement and modification parts for engines, airframes, instruments, and interiors in, and paint for, aircraft used primarily in a fractional aircraft ownership program, and sales of services for the repair, modification, and maintenance of such aircraft, and machinery, equipment, and supplies primarily used to provide those services. *(Enacted 2003)*

- **R.C. 5739.02(B)(49)** Sales of materials, parts, equipment, or engines used in the repair or maintenance of aircraft or avionics systems of such aircraft, and sales of repair, remodeling, replacement, or maintenance services in this state performed on aircraft or on an aircraft's avionics, engine, or component materials or parts. As used in division (B)(49) of this section, "aircraft" means aircraft of more than six thousand pounds maximum certified takeoff weight or used exclusively in general aviation. *(Enacted 2008)*

- **R.C. 5739.02(B)(50)** Sales of full flight simulators that are used for pilot or flight-crew training, sales of repair or replacement parts or components, and sales of repair or maintenance services for such full flight simulators. "Full flight simulator" means a replica of a specific type, or make, model, and series of aircraft cockpit. It includes the assemblage of equipment and computer programs necessary to represent aircraft operations in ground and flight conditions, a visual system providing an out-of-the-cockpit view, and a system that provides cues at least equivalent to those of a three-degree-of-freedom motion system, and has the full range of capabilities of the systems installed in the device as described in appendices A and B of part 60 of chapter 1 of title 14 of the Code of Federal Regulations. *(Enacted 2008)*

These sales tax exemptions/caps have allowed Ohio to attract and retain major employers who have made significant investments in both personnel and facilities at airports across the state. At a minimum, we strongly believe these expenditures should be maintained.

Ohio has been very fortunate to have attracted major employers like NetJets, FlightSafety, and PSA Airlines due in large part to these exemptions. These gains are in addition to the jobs sustained by aviation hubs around NASA Glenn Research Station in Cleveland and Wright-Patterson Air Force Base in Dayton. We've also seen significant jobs creation at our commercial and general aviation airports. Without an aviation-friendly tax climate, we would not have seen such success.

While I understand the committee is currently reviewing Ohio's tax expenditures, I would like to raise another tax issue that our organization feels is vital to the long term viability of Ohio's aviation sector. Currently, general aviation fuel is subject to the state sales tax; this is not consistent with other forms of vehicle taxes, which are subject to the motor vehicle fuel tax. According to the Ohio Department of Transportation, aviation fuel sales generate approximately $15.9 million in revenue for the state each year; additionally, $2.6 million is generated by county sales tax add-ons. Even with record low fuel prices, this structure makes Ohio's aviation fuel taxes higher than many nearby states.

The Ohio Aviation Association has been working on a proposal to transition aviation fuel from the state sales tax to a lower, fixed rate per gallon excise tax. This tax would be similar in structure to the current motor vehicle fuel tax, though we would like to set the rate at a level that is more competitive with our neighbors. This would allow us to fully capture this revenue and reinvest it in Ohio's aviation sector; currently, ODOT aviation funding is roughly one-third of the total revenue generated by aviation fuel sales. Other transportation segments are able to fully utilize the revenue generated by motor vehicle fuel.

Overall, Ohio's tax climate towards aviation and aerospace is very favorable. We appreciate the General Assembly's efforts in recent years to lower taxes on small businesses and willingness to support job creation through targeted tax exemptions. I apologize that neither myself nor another representative of our organization was able to be present for today's hearing. We look forward to discussing this important topic with you in the near future.

Thank you for your consideration, please do not hesitate to contact our organization if you would like additional information.

Sincerely,

Greg Heaton
President
Ohio Aviation Association

Policy Matters Ohio

Tax Policy

March 22, 2016

Testimony to the 2020 Tax Policy Commission on tax expenditures

By Zach Schiller

Chairmen Peterson and McClain and members of the committee: My name is Zach Schiller and I am research director at Policy Matters Ohio, a nonprofit, nonpartisan organization with the mission of creating a more prosperous, equitable, sustainable and inclusive Ohio. Thank you for the opportunity to testify regarding the exemptions, credits and deductions in the state tax code known as 'tax expenditures.'

We are glad that the committee has taken up the broad topic of tax expenditures, going beyond tax credits. My comments will address tax expenditures. I hope that when the commission takes up other elements of the state's tax structure I will have the opportunity to make additional recommendations.

Overall, as you know, Ohio's 128 tax expenditures add up to nearly $9 billion a year in foregone revenue, roughly the same amount as what we spend on K-12 education. Tax credits account for just 34, or less than $1 billion, of this total. Policy Matters Ohio has done research on tax expenditures in Ohio for many years. Our most recent analysis, reviewing the state tax expenditure report, was released last month (see http://www.policymattersohio.org/taxbreaks-feb2016). Among many other things, we found that:

- More than half of the total value of tax expenditures goes to business and economic development;
- Sales-tax expenditures account for nearly two-thirds of the total value, and
- Between Fiscal Years 2014 and 2017, the historic structure rehabilitation tax credit is expected to grow faster than any of the larger tax expenditures (those worth at least $10 million in 2017). I hope you will review our findings.

Some tax expenditures have worthwhile purposes. Take the earned income tax credit (EITC). As a group, lower- and middle-income Ohioans pay more of their income in state and local taxes than upper-income Ohioans do. Though with changes Ohio's state EITC could be a much more powerful anti-poverty tool, it provides help for at least some working families to help ends meet and counteract the regressive nature of our tax system.

However worthwhile they may be, tax expenditures deserve the same scrutiny as legislative appropriations. Though their origins may be murky, many tax expenditures have continued for decades, draining state revenue, providing a special advantage, without an accounting for whether they serve their original purpose or any purpose at all. The 2020 Tax Policy

Commission should request that the Department of Taxation and the Legislative Service Commission detail their understanding of why each of these expenditures was originally approved, and whether that purpose is being met now. Beyond the commission's own review, a permanent mechanism for regularly analyzing every tax expenditure should be approved.

House Bill 9 would take a useful step in that direction by requiring a review of tax expenditures every eight years. The bill should be strengthened in a number of ways. To begin with, a more frequent review would be useful. Rep. John Adams recommended tax expenditures be reviewed every two years in his report on a special House committee that heard testimony in five cities across the state in 2011 on this and other tax issues.

House Bill 9 would have a more significant impact if it included automatic sunsets for tax expenditures, so they expired unless the General Assembly reauthorized them. There is no guarantee that the state will continue spending each biennium on specific line items, and there should be no such guarantee for spending through the tax code. The worth of each expenditure should be proven, just as legislative appropriations are tested in the budget process. In addition, the Legislative Service Commission should be given the resources to do a thorough study of each tax expenditure prior to its examination by the review committee. The governor, who under the bill must include the review committee's most recent report in the budget proposal, should also recommend whether any recently evaluated tax expenditures should be continued, modified, or terminated.

The legislative committee that would be created under House Bill 9 should remain a legislative committee, without representation of business or other outside interests. The committee can seek expert advice from whomever it chooses, business included, and it's reasonable to expect it will do so. However, over half the value of tax expenditures goes to businesses. Including business representation would create conflicts of interest, or perceived conflicts of interest, when the review should be overseen by legislators.

The General Assembly also should be cautious about relying on dynamic analysis of tax expenditures. A dynamic analysis tries to predict how tax changes might affect the economy, which could in turn boost or shrink revenues over time. Ohio's last public experience with such modeling – the analysis of the proposed 2005 tax package of Gov. Taft – was not salutary. The analysis made no attempt to include the economic effects of the spending cuts or tax increases that would be needed to make up for the loss of tax revenue. As a result, it didn't provide a meaningful picture of what the tax cuts would mean. The state does not use dynamic modeling in its budget-making process. Budget Director Tim Keen, a member of this committee, noted during a budget hearing last year that, "To me, dynamic modeling for use in revenue estimates does not meet the test of conservative forecasting and conservative revenue projection." Results from such analysis depend heavily on the assumptions used, and the effects are likely to be both small and uncertain.

The Tax Expenditure Report should be expanded to include estimates of the effects of each tax expenditure on local governments, a description of who benefits from each tax expenditure, estimates of the number of beneficiaries for each tax expenditure, and if possible, the effects on Ohioans of different income groups. Each of these things is already done in some other states.

This would speed the work of the review committee to be created under House Bill 9, which would be examining these issues, while making more information available to the public about tax expenditures on an ongoing basis.

A significant number of existing tax expenditures should be repealed or limited. These include a number that Governor Kasich recommended limiting or eliminating in his executive budget last year. For instance, he proposed:

- Eliminating the tax credit and discount that sellers of beer, wine and mixed beverages get for paying their alcoholic beverage tax a few weeks in advance;
- Limiting the amounts retailers can receive for collecting the sales tax, known as the vendor discount. Most states either have no discount at all or cap the amount, ensuring that big retailers do not reap a windfall. Indeed, Tax Commissioner Joe Testa said in testimony that Ohio's 0.75 percent discount "essentially functions as a profit center" for big-volume retailers. According to data in the 2009 tax expenditure report, more than half of the $50.7 million received in such discounts in 2008 went to the 687 retailers that collected at least $1 million in tax, while the 197,487 other retailers got the rest;
- Cutting the sales-tax exemption for trade-ins of used cars and boats in half, and
- Repealing the 2.5 percent discount that distributors of cigars, chewing tobacco and other tobacco products get for timely payment of their taxes. "It shouldn't be necessary to reward businesses for paying their tax on time," as Testa noted.

Together those changes would have generated more than $130 million in extra state revenue by 2017.

Those are hardly the only tax expenditures in need of limitation or repeal. The state offers a write-off against the commercial activity tax for losses that big companies experienced before the tax was enacted, even though they no longer pay taxes on their income. This credit was only available to companies with such deductions that amounted to more than $50 million, making it clearly discriminatory against smaller businesses. The tax code features a sales-tax exemption worth more than $27 million a year for pollution-control equipment purchased by utilities even though most of it is mandated, and a cap on sales tax for wealthy buyers of shares in jet aircraft, who pay only a fraction of the tax they would otherwise.

Unfortunately, unproductive tax expenditures are not limited to those passed years ago. The largest example is the deduction from the state income tax for owners of businesses such as partnerships, S Corporations and limited liability corporations who pay personal income tax on their profits. The supposed purpose of this break is job creation and economic development. Yet the initial tax break, approved in 2013, did not produce overall job gains for the state, or a significant increase in employment at small businesses that were hiring employees for the first time. Still, it was vastly expanded last year, and could cost upwards of $800 million a year when fully implemented. Business owners in general hire or expand when there is a growing market for their products or services, not because they have more cash in their wallets from lowered taxes. The average tax savings in 2014 from the deduction was about $1,050, with most claiming far less than that. That's hardly enough to hire anyone. Yet it adds up. Say you work as an employee of a landscaping business, and pay income tax on your earnings. If you instead did the identical job, but as a contractor working for your own one-person company, you could use this deduction to avoid all Ohio income tax on the first $250,000 in income. This violates a tenet of sound taxation: That businesses and persons with similar assets and income should be taxed alike.

Other tax breaks that are not specifically deemed to be tax expenditures by the state also could be tightened. For instance, twice in the last decade, the General Assembly has acted to loosen the residency test for the income tax, allowing many affluent individuals to avoid paying the tax. And though services account for an increasing share of the economy, Ohio's sales tax does not automatically cover them; they must be explicitly included in the tax code. The sales tax now is the largest source of state tax revenue, but its base is narrowing as a share of the economy. This is a subject in need of additional study.

A number of tax expenditures, like the CAT credit for net operating losses mentioned earlier, provide special advantages for large companies. Overall, nearly $81 million or 43 percent of tax credits reported against the commercial activity tax last fiscal year went to the 68 companies with Ohio gross receipts of $1 billion. That was also more than double these billion-dollar-companies' share of CAT tax liability. Meanwhile, the other 159,485 companies that sent in tax returns got just 57 percent of the credits.

Since its initial creation a decade ago, the exclusion from the commercial activity tax of qualifying distribution center receipts has grown to be worth $157 million this year. The LSC estimated when the tax break was created that it would cost up to $39 million in Fiscal Year 2010. Suppliers to big Ohio distribution centers with more than $500 million in sales (and more recently certain metal refiners) don't have to pay the tax on such sales under this exclusion, as long as more than half of what each center ships goes outside Ohio. That makes it the 16th largest tax expenditure. It covers nine facilities. We encourage the commission to examine further who is benefiting from our business tax breaks and whether that is appropriate.

To the degree that the state has eliminated tax expenditures in the last decade or so, it has largely been by repealing entire taxes, not through a discriminating review of tax breaks. Between 2003 and 2013, 49 of Ohio's 138 tax expenditures were eliminated because of the repeal of the estate tax and the corporate franchise tax, and the change in the taxes covering local telephone companies. Yet the total number of tax expenditures fell only to 129, as existing tax credits were transferred for use against other state taxes, and new tax breaks were approved. When the new financial institutions tax was created in place of the corporate franchise tax for financial companies, a major tax break for banks on goodwill and abandoned property went away, too. As the administration described at the time, this had been a major avenue for tax avoidance. Regrettably, the additional revenue generated from the end of this tax break was given back to the banks in the form of rate cuts and the bill also contained new loopholes.

In the last two biennial budget bills, several tax breaks have been means-tested, such as the homestead exemption (for those turning 65), the $50 senior credit and the retirement income credit. The committee should look into the possible means-testing of property-tax rollbacks as well. Besides the homestead exemption, Ohio has two other state programs that provide reductions in taxes to property owners. In each case, the state reimburses school districts and localities for the revenue they would otherwise not receive. One program rolls back the property tax by 10 percent from what non-commercial owners would otherwise pay; the other provides a 2.5 percent rollback for owner-occupied properties. As the Taft administration noted in a 2003 release, "While the rollbacks are tax relief mechanisms, they are not limited to taxpayers that necessarily need tax relief." Gov. Taft proposed at that time to limit these two tax-reduction programs to the first $1 million in market value of each property.

That wasn't the first time that such a cap on eligibility was proposed. In 1995, Gov. George Voinovich put forward in his executive budget a plan to limit the two rollbacks to just the first $200,000 in value. The $33 million in savings over the biennium was to be used to increase funding for primary and secondary education. Neither Taft nor Voinovich's proposals were approved. The General Assembly should consider a cap of no more than $1 million.

As Gov. Voinovich proposed with the rollbacks, funds made available from unproductive tax breaks should be invested in public services, not given away in tax cuts. Ohio can ill afford to continue with unnecessary tax breaks when college is unaffordable to many students, infant mortality is among the highest in the nation, vacant, abandoned properties dot our cities, mass transit is underfunded and insufficient, and availability of pre-kindergarten and child care assistance lags behind that of other states. These and other needs require more investment—investment that a judicious pruning of our overgrown tax expenditures could help provide. Thank you very much for the opportunity to testify.

Policy Matters Ohio is a nonprofit, non-partisan research institute with offices in Cleveland and Columbus.

Co-Chairs Senator Peterson and Representative McClain and members of the 2020 Tax Policy Study Commission:

Thank you for asking the Ohio State Bar Association to provide its position on the expansion of the state sales tax to lobbying services. I am Todd Book, Director of Policy and Government Affairs for the OSBA. The OSBA, through its taxation experts, has been called upon several times over the last few years to discuss proposals to expand the sales tax to services. Routinely and consistently, the OSBA has counseled against such expansion. I will outline our continued concerns with the expansion of the sales tax to services including lobbying services.

1. The sales tax is intended to be a tax on end consumption. To the extent the tax applies to business inputs, it runs contrary to the fundamental purpose of the sales tax.

2. Imposing a sales tax on services is difficult to administer in terms of scope. The history of the tax on Employment Services has taught us this, and the recent Information Release from the Department of Taxation suggesting an expansion of the definition of Electronic Information Services is another example of this "service creep" phenomenon. The service economy is dynamic and rapidly evolving, and unlike tangible personal property, the definition of what constitutes a particular service can be malleable. A tax on lobbying, however defined, is all but certain to lead to controversy and litigation.

3. Imposing a sales tax on services is difficult to administer in terms of sourcing. How should this tax be sourced for lobbying national legislators? If a Congressional Representative or Senator is in his or her district office when a legislator meets, should that be taxable to Ohio, or should the tax be sourced where the benefit is received on a national basis? If the meeting is with an Ohio legislator, is this a boon to Franklin County where most meetings with legislators take place and where most lobbyists are located, or is the benefit received in the various Counties where the purchaser has its operations? Should the tax be sourced where the taxpayer is located if that is out of state? What if legislation is passed over a purchaser's objection; was any benefit received at all? Additionally, who would be included as a lobbyist? Would you have to be registered as a lobbyist to have the tax apply or would every time a person bends the ear of an elected official would the tax apply?

4. Continuing with the sourcing problem, what if the lobby service is only part of the work performed? When a client engages a law firm that employs a lobbyist as part of a legal engagement, if lobbying is taxable, it could make part of the legal engagement taxable. This creates the same problems with the attorney-client privilege that taxing legal services

would – any audit necessarily would involve review of invoices that could breach client confidences at the least, and potentially the attorney-client privilege. This also creates the same administrative difficulty present in other areas of taxing services – if the lobbying service and other legal services are provided together, even if the legal service is the true object of the engagement and the lobbying is a de minimis portion, is it necessary to state the lobbying service separately in order to avoid the risk that taxing authorities would consider the entire transaction taxable?

5. Lastly there is the issue of the First Amendment to the U.S. Constitution. There are real concerns over whether a tax on lobbying services violates the First Amendment rights of the person paying the tax. Is this a tax on one's right to petition the government for the redress of grievances? As we all know, the power to tax is the power to destroy. I am not saying definitely that a tax on lobbying services is a violation of a person's First Amendment rights but it is an issue that will need to be carefully addressed.

For the reasons outlined, the OSBA continues to be opposed to the application of sales tax to services, including lobbying services.

OHIO LOBBYING
ASSOCIATION

Statement to the 2020 Ohio Tax Policy Study Commission from the Ohio Lobbying Association Regarding Application of Sales Tax to Lobbying Services

Wednesday, March 30, 2016

Co-Chairs Senator Bob Peterson, Rep. Jeff McClain and members of the 2020 Tax Policy Commission:

On Monday, Feb. 2, 2015 Gov. John Kasich unveiled details of the administration's two-year budget blueprint that was later officially introduced in the legislature as HB 64. One component of the bill was a provision to apply sales tax to lobbying services. The Ohio Lobbying Association, following a vote of the organization's board of trustees, officially opposed this provision. The OLA filed comments with the House Finance Committee listing a number of reasons for our opposition. **This position remains unchanged to this day.** Prior to passage by the Ohio House all of the provisions to expand the sales tax to a variety of service industries were deleted from HB 64 and the budget ultimately was passed without any of these sections.

We view lobbying services as a form of constitutionally protected free speech in that the ability of citizens, businesses and other organizations to communicate with elected officials should never be unnecessarily impeded. The need for businesses, particularly those that are heavily regulated by the state, to retain lobbying services is often necessary to comply with state regulations. Like the other taxes proposed in the budget, such as management consulting services, expansion of the sales tax drives up the cost of doing business in Ohio. The burden of paying a sales tax on lobbying services would fall unequally on certain types of businesses. In other words, any proposed tax would hit those businesses and groups that needed full-time lobbying services as opposed to those that only occasionally or perhaps never need the services of a lobbyist.

Many businesses and industries that are regulated by the state often band together to form a non-profit trade association to represent their collective interests before the legislature and various boards and commissions. These trade associations often in turn retain the services of an independent lobbyist. An expanded sales tax would increase these costs and reduce the resources available to provide other association member benefits.

We should also point out that virtually every state agency and department has individuals who lobby the legislature. This category of legislative agent would not be subjected to paying sales tax when they perform exactly the same duties as independent, multi-client lobbyists do on behalf of their private sector clients.

In closing, the OLA believes applying sales tax on lobbying services is ill conceived and at the end of the day only applies to one segment of the lobbying profession. For these reasons the OLA remains adamantly opposed to expanding state sales taxation to lobbying services.

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Thank you for the invitation to present our views on this important point of tax policy. The Ohio Lobbying Association is the voice of the lobbying community representing 365 professionals from all aspects of the public policy profession. For further information you can contact any member of the Ohio Lobbying Association Board of Trustees:

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Ohio 2020 Tax Policy Study Commission
Regarding Taxation of Moist Smokeless Tobacco

Testimony of Monte Williams

March 30, 2016

Mr. Chairman and Members of the Committee, thank you for the opportunity to speak today.

My name is Monte Williams, and I am offering testimony to the Committee today, on the behalf of Altria and its affiliates Philip Morris USA, John Middleton and US Smokeless Tobacco Company regarding the taxation of moist smokeless tobacco.

My comments and opinions are based on a 30 year career with the California State Board of Equalization. I have held the positions of Chief of Excise Taxes and Chief of Criminal Investigations during my tenure with the Board of Equalization. I have over 20 years of experience with tobacco tax administration and enforcement at the state level. I am a past chair of the FTA Tobacco Tax Section. Since leaving government 10 years ago, my practice has been almost exclusively dealing with tobacco issues.

I am here today to support a proposal we believe will address a needed reform in the tobacco tax area and close an unintended loophole.

The ad valorem system of taxation for moist smokeless tobacco ("MST") worked fine when the tax was first adopted, but today it is broken and needs to be fixed.

Excise taxes are traditionally a consumption tax and typically based on a measuring unit of that item. Thus, the excise tax on wine is measured by wine-gallon, and cigarette excise taxes are measured by the stick or pack. A bottle of wine carries the same amount of excise tax, regardless of whether it is inexpensive "jug" wine or a fine merlot. A pack of premium brand cigarettes carries the same amount of excise taxes as a price-value brand. Sales taxes, by contrast, are traditionally levied based upon the price of the product.

When Ohio first placed a tax on other tobacco products (OTP) – all tobacco products other than cigarettes – the tax was levied on a percentage of the wholesale price. This was done because the OTP category was very large and diverse. It included cigars, MST, pipe and roll-your-own smoking tobacco, plug, twist, chewing tobacco, among others. MST was the largest portion of this category and most MST sold for approximately the same price. The ad valorem tax method was the easiest and most efficient way to collect taxes and resulted in approximately the same tax on each can. Many years later, however, the evidence is solid – this system is no longer working for the state and it is time to change the tax method on MST.

The MST market has changed dramatically since Ohio adopted the ad valorem tax system. There has been the introduction of many more brands into this tobacco segment, at many different price points – generally, at discount price points. Since 2001, we have seen deep discount entries into the MST segment, all of which end up paying less tax per can of product to the State than premium MST products, since the tax methodology is ad valorem – based on the price. In fiscal year (FY) 2015, discount brands accounted for approximately 70% of the market in Ohio.[1] Ten years ago, in FY 2005, it was only 35% of the market.[2]

While OTP revenues have grown, the MST portion of the Total OTP revenue has not kept pace. In 2006, MST revenue was estimated to be 48% of total OTP revenue and is

[1] ALCS STARS sales database as of November 8, 2015.
[2] ALCS STARS sales database as of November 8, 2015.

approximately the same amount of revenue today. However, during this same period the volume of cans sold grew 90%.[3]

This dynamic is not present with cigarettes, gasoline, or any of the other excise taxes – because those excise taxes are based on unit, not price.

Proponents of an ad valorem methodology argue that as product prices in this category increase, an ad valorem MST tax will automatically generate increased revenues over time. *The truth is that prices in this category fluctuate – they do not steadily increase.* Under an ad valorem system, when prices decline, the state loses tax revenue. Thus, the state's tax revenue stream is largely dependent on the pricing structures of the manufacturers. For example, in 2009, US Smokeless Tobacco Company cut the price on Copenhagen, Skoal, and Red Seal by 20% and was followed one week later by The American Snuff Company, a division of Reynolds American, who cut prices on Kodiak, Hawken, and Cougar by a similar amount.[4] This price reduction in 2009 cost the state of Ohio nearly $1 million in FY 2010.[5] More recently, in January 2013, Swedish Match reduced its list price for Longhorn by 31% and Timber Wolf by 49%.[6] The average price of a can of MST in 2015 was approximately the same as it was in 2006.

Today, 22 states and the federal government tax MST products based on weight or unit. In fact, 16 of these states have converted to a weight-based type tax system since 2006, as more and more states are coming to realize the problems with an ad valorem system. A weight based tax system gives the state a revenue stream that is stable and easily estimated from year to year, and one that is not reliant on company price policies and marketing programs. It also creates tax equality between similar products and returns to a more

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[3] ALCS STARS sales database as of November 8, 2015 and Bill Orzechowski & Rob Walker, The Tax Burden on Tobacco funded in part by Altria Client Services.
[4] Price data is based on publically available information.
[5] ALCS STARS database dated November 8, 2015.
[6] Cspnet.com *at* http://www.cspnet.com/news/tobacco/articles/swedish-match-rolls-back-prices-longhorn-timber-wolf?utm_source=SilverpopMailing&utm_medium=email&utm_campaign=Daily%20News%2001-16-2013%20(1)&utm_content=&spMailingID=40835531&spUserID=MjU0MDQ2MTQ5MzkS1&spJobID=174517692&spReportId=MTc0NTE3NjkyS0.

traditional excise tax system. In addition, once in place, a weight based tax system is easier to administer for both the state and the wholesalers.

Let me be clear: we strongly urge Ohio to adopt a weight-based type tax system. However, if Ohio finds it necessary to maintain a smokeless tax based on price, at the very least, it should impose a minimum tax to avoid losing revenue. In fact, key findings from a 2015 survey of registered voters in Ohio show that Ohioans supported a minimum tax for MST.[7] In fact, 77% of respondents agree that adding a minimum tax closes the tax loophole that exists under the current ad valorem structure. A minimum tax would provide more revenue security for Ohio, in the event Ohio is unwilling to adopt a weight-based type tax system.

Furthermore, in 2013, the Campaign for Tobacco Free Kids ("CTFK") released an article called, "The Best Way to Tax Smokeless Tobacco."[8] While CTFK supports smokeless taxes based on price, it does acknowledge that adding a minimum tax will bring in more revenue. The article states,

> ***"Moreover, adding minimum tax will also bring the state new revenues (and public health benefits) both in the short term and over time."***

For the reasons stated above, Ohio should close the MST tax loophole and join the 16 other states that recently did the same by taxing MST in the same manner as cigarettes, alcohol and gasoline.

Thank you for your time and I will be happy to try to answer any questions.

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[7] ALCS Research
[8] Campaign for Tobacco Free Kids, Ann Boonn, August 1, 2013, *at* https://www.tobaccofreekids.org/research/factsheets/pdf/0282.pdf

Micah Berman, JD
Assistant Professor, Ohio State University
March 30, 2016
Ohio 2020 Tax Policy Study Commission

Senator Peterson, Representative McClain, and Members of the Commission:

My name is Micah Berman and I am an assistant professor of public health and law at Ohio State University. I am a member of the OSU-James Comprehensive Cancer Center and a steering committee member for Ohio State's federally-funded Center of Excellence in Regulatory Tobacco Science. I teach courses on Public Health Law and Tobacco Regulation, among others, and I have been studying tobacco policy for more than a decade.

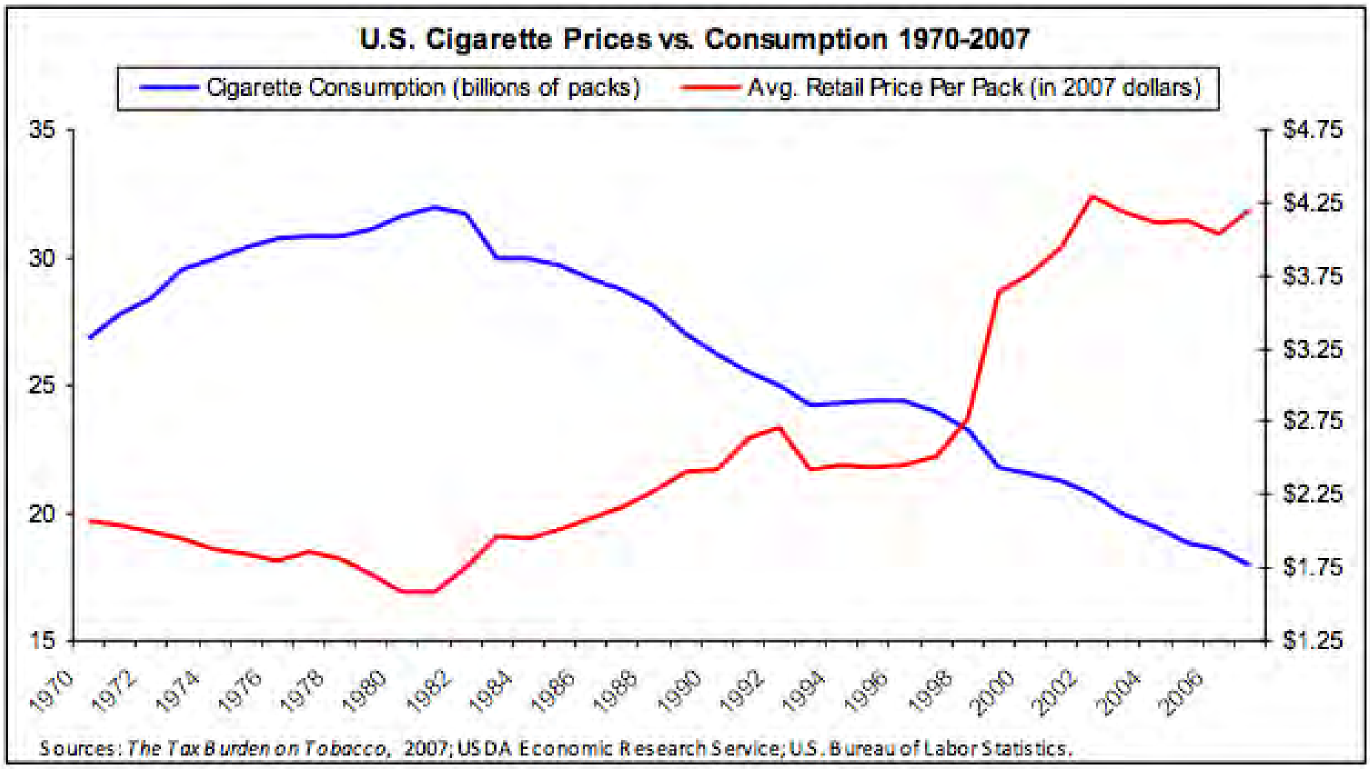
I am here this morning as a volunteer, not a paid spokesperson, speaking to you on behalf of the OSU-James Comprehensive Cancer Center and the American Cancer Society Cancer Action Network (CAN).

As I'm sure you all know, tobacco is the leading cause of death in Ohio and in the nation, killing nearly half a million Americans and more than 20,000 Ohioans every year. If current trends continue, more than 250,000 Ohio kids alive today will die prematurely from a tobacco-related disease. Despite progress that has been made over the years, reducing tobacco use and protecting the next generation from nicotine addition remains critical for Ohio – critical for our health, and also critical for our economy.

Right now, **Ohio is ranked 44th** in terms of adult smoking, meaning that there are only a handful of states with higher smoking rates. Moreover, smoking rates among Ohioans on Medicaid are staggeringly high. The 2015 Ohio Medicaid Assessment Survey estimated that more than 40% of Medicaid enrollees aged 19-64 were current smokers. Thus, it should not come as a surprise that Ohio spends $1.7 billion each year to treat smoking-related diseases, which is considerably more than then roughly $1 billion the state receives annually in tobacco tax revenue. Reducing tobacco use is one of the most straightforward ways to reign in Medicaid costs.

Addressing tobacco use is also central to taking on the challenge posed by infant mortality. A significant cigarette tax increase would prevent thousands of spontaneous abortions, still-births, and low-birthweight babies. In addition, such a tax would reduce infants' exposure to secondhand smoke, which can be a cause of asthma attacks, respiratory infections, ear infections, and sudden infant death syndrome (SIDS).

We know from decades of research that tobacco taxes are **the #1 most effective policy lever** for reducing tobacco use. Literally hundreds of peer-reviewed studies have shown that a 10% increase in the price of cigarettes reduces cigarette consumption overall by 3-5%, with an even larger impact on youth. The once-secret tobacco company internal documents show that they have recognized the powerful impact of tobacco taxes for decades. Despite claims to the contrary, higher cigarette taxes reliably reduce use (not just sales, but use), despite concerns that smokers will turn to cross-border purchases, the Internet, or the black market. Simply put, there a very clear inverse relationship between prices and use, even when accounting for these other potential factors. Higher tobacco taxes save lives.



Source: Campaign for Tobacco-Free Kids

With my remaining time, I'd to provide some background on Oho tobacco taxes, discuss the Other Tobacco Products (OTP) Tax, which is not been raised since 1993, and address the issue of weight-based vs. price-based taxation.

Background on Tobacco Taxes in Ohio

Last year, the General Assembly raised the cigarette tax by $0.35/pack to $1.60/pack. While this was movement in the right direction, there is wide agreement in the research literature that a tax increase of $0.35/pack is too small to have any significant public health impact. Even considering this increase in the cigarette tax rate, the American Lung Association, which grades state tobacco policies, still awarded Ohio an "F" overall on tobacco tax policy.

The General Assembly did, however, significantly increase funding for state tobacco control programs, to a total of about $14 million (counting both federal and state funds). While the increase was significant, Ohio is still spending only about 10% of the amount recommended for tobacco control by the Centers for Disease Control and Prevention's evidence-based best practices recommendations. In addition, that $14 million figure must be viewed in context. It is only 3% of the amount that the tobacco industry spends on marketing its products in Ohio each year, and just over 1% of the amount of tobacco-related revenue the state receives in a given year.

From 2002-2008, Ohio had a well-funded tobacco control program, which I was proud to be a part of, that made great strides in reducing tobacco use in Ohio. This progress was reversed after the Ohio Tobacco Prevention Foundation was dismantled in 2008. What the additional tobacco-related funding added to this biennial budget was extremely valuable, much more is needed for Ohio to have a truly effective tobacco prevention and cessation program in place.

In short, is clear that if Ohio is to make progress in reducing tobacco use, two things must happen: (1) the state needs to significantly raise tobacco taxes, and (2) some portion of that money needs to be dedicated to tobacco prevention and cessation.

Notably, recognizing the connection between tobacco use and infant mortality, Ohio Infant Mortality Commission made essentially the same recommendations last week in its Commission report (although it recommended spending the money from a tobacco tax increase on infant mortality prevention).

Other Tobacco Products (OTP) Tax

While increasing cigarette taxes is critical, I also wanted to emphasize the importance of addressing Ohio's Other Tobacco Products (OTP) tax. Ohio's OTP tax, which is set at 17% of wholesale price (with the exception of little cigars, which have a higher tax rate), **has not changed since 1993** – twenty-three years ago. There is only one state in the entire country that has gone longer without raising its OTP tax.

While Ohio's smokeless tobacco use rate is not much higher than the national average, there are parts of Ohio—particularly in the Appalachian counties— where smokeless tobacco use (particularly among young boys) is especially high. As with cigarette taxes, the OTP tax has its largest effect on youth. Increasing the OPT tax can prevent thousands of kids from starting down a path of nicotine addiction that can ultimately lead to mouth cancer, throat cancer, esophageal cancer, and numerous others painful and expensive diseases that result from smokeless tobacco use.

Increasing the OTP tax also helps to reduce *dual use* – the concurrent use of multiple forms of tobacco. While I do not have data from our studies to report today, the issue of dual use is a focus of our research work at Ohio State, because there is reason to believe that dual use may lead to faster addiction, deepened dependence, and more difficulty quitting.

In addition to smokeless tobacco, the OTP tax also applies to products like pipe tobacco and roll-your-own tobacco. When the OTP tax is significantly lower than the cigarette tax, as it is now, it encourages consumers to purchase roll-your-own tobacco rather than manufactured cigarettes. This form of tax avoidance serves no public health purpose and only costs the state income.

I urge you to recommend increasing the OTP tax to 40% of wholesale price, which would make it roughly equivalent to the cigarette tax. Further, the new revenue from the higher OTP tax should be used to fund tobacco prevention and cessation programming.

<u>Weight v. Price-Based Tax</u>

Finally, on issue of *how* to tax other tobacco products, Altria—the parent company of Philip Morris and U.S. Smokeless Tobacco (UST)—has been urging state legislatures to move from a price-based tax to a weight-based tax. I urge you to reject that approach.

For one, a weight-based tax does not keep pace with inflation. Imagine in Ohio's OTP tax had been set by weight in 1993. Such a tax would be about 60% lower today in real dollar terms than a price-based tax. Such a tax would be a good deal for Altria, but would be less effective in both reducing tobacco use and in generating revenue for the state.

Secondly, weight simply has nothing to do with how hazardous a product is. A weight-based tax will drive the market towards "lighter" tobacco products, but not less hazardous ones. This would benefit certain companies—again, like Altria—but not provide any benefit to public health. At the same time, it would make some products—the lighter ones—particularly attractive to youth because of their lower prices.

In comparison to weight-based taxes, which may benefit some manufacturers at the expense the public, price-based taxes are simply fairer, easier to implement, and better for public health. I therefore urge you not recommend the use of weight-based approach.

***

In the most recent Surgeon General's Report, issued in 2014, the Surgeon General stated very clearly that "raising the average excise cigarette taxes to prevent youth from smoking and encourag[e] smokers to quit" is one of the key policy measures that "should be implemented" by states.

There is overwhelming evidence that tobacco tax increases—whether for cigarettes or Other Tobacco Products—(1) improve public health, which will make Ohio more economically attractive and competitive, (2) increase state revenue in a reliable and predictable ways, and also (3) reduce health disparities (which I did not have time to talk about today).

I ask you to please support the recommendations outlined above, and I would be happy to answer any questions.

OHIO WHOLESALE MARKETERS ASSOCIATION

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2020 TAX POLICY STUDY COMMISSION

Beth Wymer, Executive Director
Ohio Wholesale Marketers Association
March 30, 2016

Co-Chairman Peterson, Co-Chairman McClain and members of the Commission, thank you for the opportunity to be here today. I've been asked to discuss the important role that the Ohio Wholesale Marketers Association's distributor members have as the front end payers of Ohio's cigarette and other tobacco product taxes, and the cigarette stamping and other tobacco product compensation that they receive for the services they provide for the state.

OWMA's core membership is wholesalers who supply products to convenience stores (c-stores), mom-n-pop corner stores and similar retailers. With few exceptions, the Association's distributor members are Ohio-based family-owned businesses that have served their communities for one or more generations. Wholesalers to c-stores are high volume low profit margin businesses, with the typical wholesaler having a pretax profit margin of about one percent.

These wholesalers sell much more than just tobacco, but the tobacco category-- which includes cigarettes and all other tobacco products--accounts for 70 to 80 percent of a typical wholesalers overall sales volume. For the smallest wholesalers, the category represents about 90 percent of overall sales.

When the current fiscal year closes, the state will likely have collected well over $800 million in tobacco category taxes. The tobacco tax category represents the fourth highest tax revenue source for the state general revenue fund, and Ohio's wholesalers have many costs associated with making sure the state gets that money.

The cigarette excise tax is actually an immediate tax on wholesalers who must buy cigarette excise tax stamps from the state and affix the stamps to each pack of cigarettes before selling the product to retailers.
The presence of a stamp on a pack of cigarettes shows that the tax has been paid.

One roll of cigarette tax stamps has 30,000 stamps, enough for 50 cases of cigarettes. At today's tax rate of $1.60/pack, one roll of stamps costs the wholesaler $47,136, which is the tax rate times the 30,000 stamps minus the 1.8% stamping compensation.

A typical midsize wholesaler is running about 598 cases of cigarettes through their warehouse each month and needs about 12 rolls of stamps to cover that volume. OWMA's largest wholesaler reports needing more than 150 rolls of tax stamps per month.

For their cigarette tax stamping services, wholesalers are compensated at a rate of 1.8% of the amount of the tax, which is 2.88 cents per pack stamped.

Wholesaler costs associated with being cigarette tax agents for the state:

Purchase or lease of cigarette stamping machinery and related costs that include supplies for and maintenance of the machine, electric to run the machine, warehouse space allocated to the machine and insurance on the machine. The number of stamping machines in the warehouse and number of employees working each machine varies based on the size the wholesaler/volume of cigarettes being stamped.

Labor costs to operate the stamping machine, which includes wages, benefits, and employer taxes for the employees who operate the machinery and carry out the manual parts of the stamping process.

The stamping operation requires that the cases of cigarettes (60 cartons per case) be split into half cases so the cartons can be loaded into the stamping machine, flaps on the cigarettes cartons are opened to expose the bottom of each pack, the carton runs through the machine where the stamp is applied, then glue is applied to the flap and sealed down, and the carton gets repacked into a case to move into inventory or order fulfillment. Some cartons don't fit through the machine so they have to be stamped manually with a hand stamping iron.

Labor costs (wages, benefits, employer taxes) for personnel who handle required cigarette tax reports --
- Monthly Report of Unstamped Cigarettes Received In Ohio
- Monthly Master Settlement Agreement (MSA) Report
- Ohio Cigarette Tax Return (semi-annual)
- Report of out-of-state cigarette sales
- Report of sales to other wholesalers
- Report of cigarettes received from other wholesalers
- Annual and/or case-by-case request for Customer Data, received from Tax Department Audit Division. Customer data that wholesalers are asked to provide as part of these Audit Division requests includes retail customer cigarette license number; customer name and store name and address; and dollar sales to the customer broken out by category such as cigarettes, other tobacco products, pop, energy drinks, sundry items, etc.

Shipping charges to get tax stamps from the state. Wholesalers pay the UPS (or FedEx) charges to have the stamps shipped from the state to their warehouses, a change that was made several years ago. At that time, the state justified shifting this expense to the wholesalers with the comment "they get that 1.8%."

Insurance on stamps in transit from the state. A year ago, the state shifted another cost to the wholesalers with an announcement that wholesalers are responsible for the full face value of any stamps lost in transit to them. The full face value of one roll of tax stamps is $48,000.

Rolls of tax stamps rarely get lost in transit, but when they do get lost it is typically because a package opens during shipment and a roll(s) fall out. Thankfully, lost rolls are typically recovered at the UPS or FedEx facility.

Wholesaler options to deal with the loss risk are to declare the stamp value through the carrier at a cost of more than $300/roll shipped and the maximum coverage allowed through the carriers doesn't even cover more than one roll of stamps; or add coverage to their business insurance policies which also comes at a cost. Wholesalers also have the option to pick-up their tax stamps at the Department, but this only makes sense for wholesalers based in Columbus or who deliver into the area. Wholesalers who don't pick up their own stamps tell me that their drivers are at enough risk with stamped cigarettes in their trucks and they don't want to add to that risk by putting rolls of tax stamps in the trucks.

Insurance on stamps in inventory and stamped cigarettes in transit. The tax rate drives higher insurance rates on stamps in inventory, whether affixed to cigarettes or still on the roll, and also on stamped cigarettes in transit from the wholesaler facility to retail customers.

Warehouse and vehicle security. Cigarette tax rates increase the value of cigarettes, making them an appealing product for theft. Tactics used by thieves have ranged from hijacking delivery trucks to drilling through warehouse cinder block walls or ceilings. Wholesalers invest significant amounts of money in security systems to protect rolls of tax stamps and stamped cigarettes.

Account receivables/Bad debt. There is no law requiring that wholesalers be paid on delivery for cigarettes (there is such a law for beer/wine) so based on payment terms with retailers, it's about 14 to 20 days from the time the manufacturer debits the wholesalers bank account for the cost of the cigarettes until the wholesaler is paid by the retailer; during this time, the wholesaler carries the entire cost of the cigarettes and the excise tax. Wholesalers are still obligated to remit the taxes to the state, even if the retailer doesn't pay for the taxed product.

Wholesaler costs associated with collecting/remitting the other tobacco product (OTP) tax
Wholesalers remit the other tobacco products tax to the state every month, based on what they received into their warehouse. The compensation is 2.5% of the total tax due.

Cost of OTP tax factored into product value for insurance pruposes. The OTP tax becomes part of the cost of the product in inventory and therefore the tax is factored into inventory insurance coverage needs.

Insurance. The OTP tax becomes part of the cost of the product in inventory and therefore the tax is factored into product values for inventory insurance coverage needs for product in the warehouse and out on delivery trucks

Inventory Management Ohio has two OTP tax rates that are administered at the wholesale level. The little cigar category is taxed at one rate and a different rates applies to everything else in the OTP category. Taxing little cigars differently from everything else in the OTP category has required computer updates that add costs and inventory control changes (ie does the little cigar in inventory meet definition requirements to be taxed at little cigar rate vs other rate).

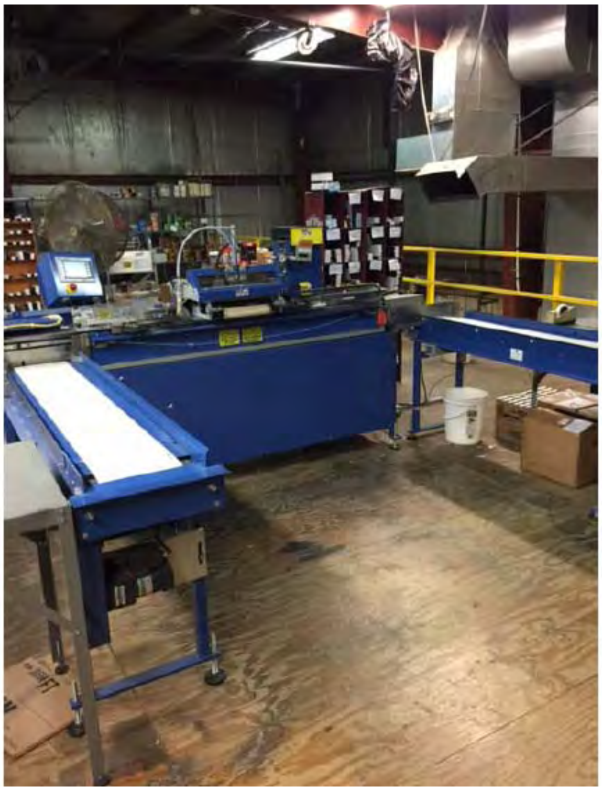
Labor costs for personnel who handle required other tobacco product tax reports --
- Monthly Other Tobacco Products Tax Return detailing untaxed OTP received by the distributor and related schedules that may include OTP sold by the distributor to out of state recipients, previously taxed product returned to the manufacturer with related schedules, little cigars subject to the tax and related little cigar schedules.
- Monthly Master Settlement Agreement (MSA) Report
- Annual and/or case-by-case request for Customer Data, received from Tax Department Audit Division. Customer data that wholesalers are asked to provide as part of these Audit Division requests includes retail customer cigarette license number; customer name and store name and address; and dollar sales to the customer broken out by category such as cigarettes, other tobacco products, pop, energy drinks, sundry items, etc.

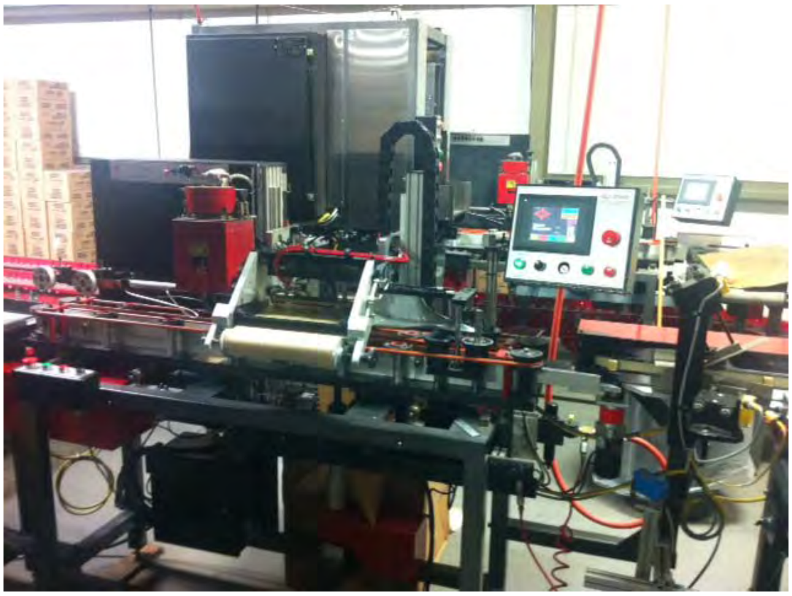
Account receivables/Bad debt. Same as with cigarettes, wholesalers are still obligated to remit the other tobacco product taxes to the state, even if the retailer doesn't pay for the taxed product.

Both the cigarette stamping compensation and OTP collection compensation have been referred to as "early payment discounts" and even "tax discounts". It has also been stated that these businesses shouldn't be rewarded for paying their taxes on time. First, if these businesses fail to remit the taxes, they can lose their cigarette or OTP license and that means they are out of business. Even more important, these are not the wholesalers' taxes --- these are the state's taxes and the wholesalers are doing a valuable service for the state at a cost to their businesses and the compensation rightfully helps cover their costs.

Thank you for your time, and I would be happy to take any questions.

Stamping Equipment





Tax Stamps on a Roll

Carton of Cigarettes before stamping and with Tax Stamps

TRAVEL TECH
The Travel Technology Association

Testimony of Stephen Shur in Opposition to Applying the State Sales and/or Lodging Tax to Travel Service Provider Fees

My name is Stephen Shur, and I am the President of the Travel Technology Association. My organization represents companies like Orbitz, Expedia, Priceline and many others.

Our industry is responsible for booking millions of room nights in Ohio annually. We are in strong opposition to any proposal that would apply the state sales and lodging tax to travel agent service fees.

First, and most importantly, online travel agents don't buy rooms in bulk at wholesale rates and resell them at retail rates.

Marriott's own representative testified to this fact in a February 11 hearing in Annapolis, Maryland. Quote:

> **"When we say wholesale, it's not the most apt analogy. Expedia doesn't pre-pay Marriott for rooms. What happens is they have access to sell, they're another conduit for selling. So, first and foremost they're not allowed to undercut us. We open that inventory, it's our inventory, and they're allowed to sell it at that price we've indicated." –Marriott Representative at SB190 Hearing, February 11, 2015.**

In the context of the question of whether the proper taxes are being levied, collected and remitted, there is no loophole. The tax is based on the rate that the hotel sets. They provide the good or service, in this case, the hotel room, to the traveler. Online travel agents do not operate hotels or have control of inventory nor do they set the price that the consumer pays for the room.

As in the case of AAA discounts or AARP discounts, the tax paid by the consumer is based on the discounted room rate that is set and agreed to by the hotel.

Why does this matter and how does it relate to this legislation? When a consumer books a room via an online travel agent or an Ohio brick and mortar travel agent, the amount the consumer pays includes the room rate, the taxes based on that room rate and a service fee that the travel agent charges the consumer for the service they provide which is providing the ability to search compare and book travel.

This legislation would require the sales and lodging tax to be collected on the total amount the consumer pays which means this new tax would apply to the service fees charged by travel agents and represents a new sales tax on services in Ohio, travel agent services, to be specific.

This is bad for Ohio tourism and particularly bad for Ohio travel agents who already pay tax on the service fees they charge their clients.

Like any new taxes, this tax would be passed on to the consumer in the form of higher hotel rates. Priceline, one of the largest online travel agencies in the world, found that a 1% increase in room rates results in a 2% reduction in bookings.

It should be no surprise that Ohio hotels will be at a distinct disadvantage to neighboring states, none of which impose a sales tax on these services.

It has been said that when you tax something, you get less of it. By way of comparison, a stated objective of increasing tobacco taxes is to reduce consumption.

In this case, we are talking about hotel bookings in Ohio.

The opportunity cost of this tax is high. It's not about raising revenue. It's not about closing a loophole that doesn't exist. It's not about leveling any playing field. It's simply a new state sales and lodging tax on services and a disincentive for online travel agents and Ohio travel agents to steer people to Ohio hotels.

This new sales and lodging tax on services is a job killer, a small business killer and a burden on Ohio businesses and citizens. I urge you to reject this proposal.

Thank you.

OHIO HOTEL & LODGING ASSOCIATION
692 N. HIGH ST. SUITE 212
COLUMBUS OH 43215-1564
P: (614) 461-6462

Proponent Testimony – Online Travel Company Tax Parity
Ohio 2020 Tax Policy Commission
Chairs: Senator Bob Peterson & Representative Jeff McClain
March 30, 2016

Chairmen Peterson and McClain, committee members, thank you for the opportunity to speak to you today in favor of Ohio's communities, our travel economy, and tax fairness for entities selling hotel accommodations in Ohio, in the form of Online Travel Company Tax Parity, H.B. 150 and S.B. 160.

I'm Joe Savarise, Executive Director for the Ohio Hotel and Lodging Association (OHLA). Ohio is home to more than 1,400 hotel properties providing more than 127,000 rooms to guests across the state. We employ more than 35,000 people directly, produce $777 million in employee wages and are an integral part of Ohio's vital travel economy. The hospitality, travel and tourism sector produces nearly $50 billion in annual sales, and $2.7 billion in taxes.

OHLA supports Online Travel Company (OTC) tax parity as a vital step in eliminating ambiguity in Ohio's tax code. The health of Ohio's travel economy relies on the intent of the law -- to require lodging businesses to remit taxes based on the full retail rate, just as businesses in other sectors must. While our members support the state's economy and efforts to bring more business and travelers to the state, they do so on an uneven playing field.

We are proposing a solution that will provide much-needed revenue to your local communities while ending the unfair competitive advantage out-of-state OTC's now have in the Ohio marketplace; all without creating a new tax. We simply seek to ensure that all are participating on equal terms.

OTC Tax Parity is a simple step to modernize the Ohio Revised Code and ensure OTCs remit tax on the price their consumers pay for the hotel room. We support the specific mechanisms included in H.B. 150 and S.B. 160 that will make this happen:

- Defining an online travel company, "hotel intermediary," as a vendor,
- Requiring hotel intermediaries to collect and remit applicable sales and use tax at the full retail price of hotel rooms, and
- Requiring transparency for consumers by requiring hotel intermediaries to supply customers with itemized invoices

Ohio hotels are required to remit tax on the retail rate paid by the customer. Out-of-state online travel companies should be required to do the same. Preventing online travel companies from taking advantage of ambiguity in our code and closing this tax loophole will keep an additional $15 million, conservatively estimated, in Ohio as taxes each year. This will be in the form of sales taxes needed by our state and local governments to provide vital services, and lodging taxes that will support local convention and visitor bureaus and bring more business and travelers -- and dollars -- to Ohio.

Approximately 20 percent of hotel reservations are made through OTCs, which contract with hotels to gain access to unsold room inventory. Contrary to popular belief, these websites do not negotiate with hotels to pass lower room rates onto consumers. They are merely an alternative booking option. For the same room type, on the same night, at the same hotel, OTCs offer consumers the same room rate as the hotel itself. What is less obvious to consumers is that OTCs retain a cut (generally 15-25 percent) of the published retail room rate as compensation, paying hotels what is akin to a "wholesale" rate for the room.

The OTCs keep as profit the undisclosed additional amount they call a "tax recovery fee" or "service fee." This amounts to a dividend at the expense of Ohio taxpayers. (See attached infographic for illustration of how this works.)

Ohio's hotel industry would like to underscore that requiring compliance with the law is by no means a "new" tax.

Lodging tax has existed as far back as the 1950s; it was included in the Ohio Revised Code in its current form in the 1960s; and was updated in the 1980s. Entities that sell accommodations in Ohio are required to collect and remit lodging tax. Online travel companies have always been liable for this tax. The problem is that OTCs exploit ambiguity in the code.

NATIONAL PERSPECTIVE

Governments across the country have come to the conclusion that this unfair difference in tax remittance needs to be addressed. In fact, the National Council of State Legislatures issued guidance in 2014 which stated: "To ensure full collection of taxes that are due and to promote equity and fairness in the tax code, states should consider requiring online travel companies to remit taxes based on the rental price paid by the user."

The Supreme Court of Georgia in 2009 upheld a permanent injunction requiring Expedia to collect and remit occupancy taxes on the full room rate. The court reasoned that occupancy taxes:

> "do not contemplate taxing the transaction between Expedia, or any other intermediary such as a traditional travel agent, and the hotel. The facts also show that Expedia is not the end-consumer, is not a member of the public at large, and it is not the occupant of the hotel room. Therefore, the wholesale rate which Expedia, a non-occupant, pays for the room cannot be the rate on which the tax is based." [*Expedia, Inc. v. City of Columbus*]

In another example, the United States District Court for the Northern District of Illinois ruled in 2011 that local occupancy tax ordinances covered online travel companies:

> "[T]he legislature intended to tax the amount customers pay to occupy a hotel room in Rosemont ... There is no dispute, however, that [the OTCs] do not obtain the right to occupy any room at any time during a transaction and their customers do so only after paying [the OTCs]. Because the record establishes that [the OTCs'] customers cannot occupy hotel rooms in Rosemont unless they pay the full amount [the OTCs] charge, [the OTCs'] fees and mark-ups are part of the rental rate subject to Tax." [*Village of Rosemont v. Priceline.com*]

In recent years, a number of states have taken action to address OTC tax parity:

1) Georgia (2009)
2) New York (2010)
1) North Carolina (2011)
2) South Carolina (2011)
3) District of Columbia (2011)
4) Montana (2012)
5) Oregon (2013)
6) Wyoming (2015)
7) Hawaii (2015)
8) Rhode Island (2015)
9) Maryland (2016)
10) Indiana (2016)

A recent Washington Post editorial endorsing similar legislation that went into effect in Maryland. Governor Larry Hogan was quoted saying:

> "You can't blame [online travel companies] for trying, but logic and equity are on the side of states that demand, justly, that online agencies remit taxes on the full payments they receive for room sales, not the discounted prices … The agents may have become used to this comfy arrangement. That doesn't make it right or equitable. It's just a loophole."

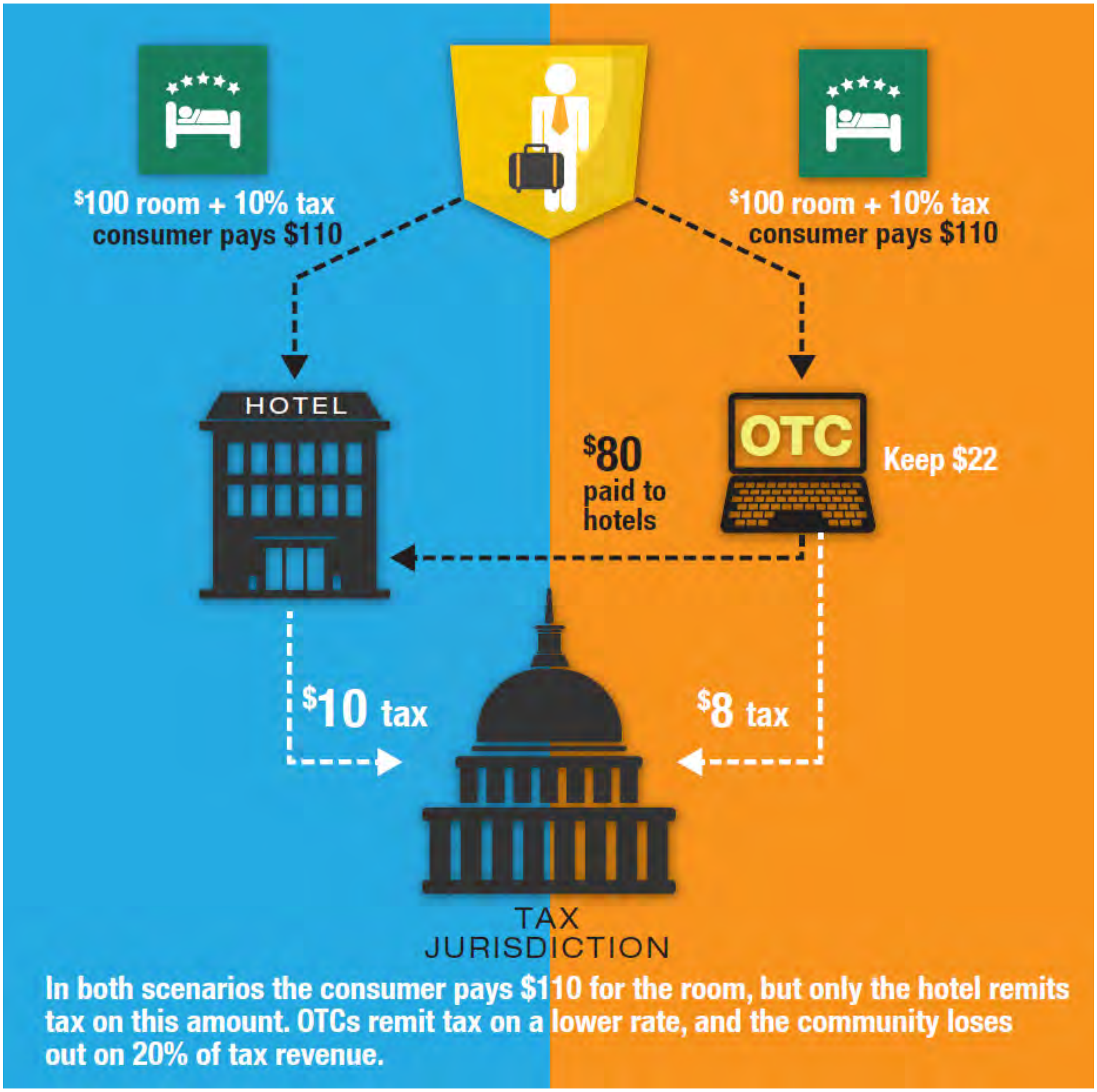
In the end, this legislation merely removes ambiguity and clarifies that there is tax parity between OTCs and hotels that sell their rooms directly.

Online Travel Company Tax Parity would clarify Ohio's sales and lodging tax codes to provide parity between hotels and OTCs like Expedia and Orbitz that act as intermediaries in the hotel reservation process. Enacting OTC Tax Parity would ensure the Ohio's brick-and-mortar hotel industry can compete for online booking traffic on a level playing field, while also shoring up critical resources that support tourism promotion, infrastructure and other vital services.

Consumers will pay the same price. OTCs are merely inflating their profits with a dividend at the expense of Ohio taxpayers. Raising their prices further will make them uncompetitive against hotel and lodging companies.

When Ohio consumers make other purchases, they expect to pay, and have vendors remit, tax on the retail rate. All Ohio's hotels follow this simple principle. At the same time, our industry is taxed different from any other, with a very specific tax. It is time for everyone to pay their fair share. Thank you for the opportunity to share our support.

Online Travel Companies Remit their Taxes at a Lower Rate than Others -- and Cost Ohio, its Communities, and Taxpayers in the Process



Graphic: American Hotel & Lodging Assn.

Testimony from Scott Ward
Satellite and Broadcast Communications Association
Thursday, April 28th, 2016
2020 Tax Policy Commission Committee
The Ohio Tax on Satellite TV Subscribers

Chairmen Peterson and McClain, and members of the 2020 Tax Policy Commission Committee, thank you for the opportunity to testify before you today on an issue that has been discussed in Ohio over the last several years – the tax on satellite TV subscribers in Ohio.

My name is Scott Ward, an attorney with the law firm of Orrick, Herrington & Sutcliffe, LLP. I am here today on behalf of the satellite television industry, including both DirecTV and Dish Network and the Satellite and Broadcast Communications Association, representing the more than one million subscribers of satellite television in Ohio. I am here to share some information about why we believe the 2020 Tax Policy Commission Committee should evaluate whether it makes sense to have satellite TV subscribers pay Ohio sales tax when no other pay TV subscribers in Ohio do. We believe that Ohio should level the playing field so that Ohio's satellite subscribers and Ohio's other pay TV subscribers are treated equally.

First, I'd like to share some important industry news that has developed since the last time we testified before the Ohio House and Senate. Last year AT&T completed its acquisition of DirecTV and they now operate as one company. According to information that AT&T shared when it closed the acquisition last summer "the newly combined company — the largest pay TV provider in the United States and the world — will offer millions of people more choices for video entertainment on any screen from almost anywhere, any time." Additionally, "Ohio consumers will see more high-speed Internet options, expanded access to content on numerous devices including smartphones, tablets, laptops, money saving bundles for phone, Internet and cable services with one convenient bill and an alternative to the local cable company." This is an exciting development for our industry and consumers in Ohio and around the country.

Now to turn to the tax issues we are here today to discuss. First, I would like to point out that we are really talking about a tax that impacts our customers, not our companies' tax bills. In most respects, the taxes that pay TV providers and customers pay are identical. But satellite TV customers must pay the state sales tax on their television service, while other pay TV consumers do not. I am being very deliberate in saying pay television services. This discussion has been framed as satellite versus cable. But today almost a quarter of Americans use "over the top" Internet streaming video services, such as Netflix, Amazon Prime, Hulu or Apple TV, for their TV service instead of cable or satellite. (Pew Research Center, December 2015). Like cable television service, those services are not subject to the state sales tax.

Now as satellite TV providers, we believe that this disparity in the taxation of like services is anti-competitive and fundamentally unfair to consumers in Ohio who in turn pay more for the same service. Furthermore, the tax on satellite TV places our overall industry at a disadvantage. Our cable competitors have always argued that the franchise fees that they are assessed by local governments and pass on to their customers are equivalent to the state sales tax that satellite television customers pay, thus making the current system fair. We of course disagree that their passing on a cost of their business - obtaining the use of local rights of way to install cables - is equivalent to a tax on the service. We have costs of doing business, like building and launching satellites, that are accounted for in our rates too. But even if you agreed with that premise, the rate of the franchise fee does not equal the state sales tax rate. Satellite television customers pay 5.75% in state sales tax - franchise fees are capped at 5% but they are negotiated with local governments and could be as low as 2%. So even in areas where competition exists, satellite TV customers pay more.

But even worse is the situation for our customers where competition is not a factor - rural Ohio. There are many communities in Ohio where cable and quality broadband internet services, necessary to use “over the top” services, are not available because those providers have made the decision not to enter those markets and serve those customers. In fact, there are many places in Ohio where getting over the air digital signals are difficult due to the topography. That means in some places, satellite television is the only option available. In effect, Ohio taxes rural Ohioans because they live in areas where other providers cannot or will not go.

The satellite TV industry believes the tax on satellite television services is unfair to our customers. Ohio is an outlier on this tax - it is one of only 5 states that has different rules for taxing pay television services - the other states are Florida, Massachusetts, Tennessee and Utah. We urge the General Assembly to reconsider the state sales tax currently imposed on satellite television services.

Testimony of Jonathon McGee

Executive Director, Ohio Cable Telecommunications Association

Before the

2020 Tax Policy Study Committee

April 28, 2016

I. INTRODUCTION

Co-chairs Peterson and McClain and members of the committee, I am Jonathon McGee, Executive Director of the Ohio Cable Telecommunications Association (OCTA), which represents cable TV operators, programmers and suppliers and their more than 8,000 full-time employees in Ohio. Thank you for the opportunity to provide testimony regarding Ohio's tax policy and the OCTA's positon.

My testimony will show that current tax policies in Ohio create a fair, level playing field for competing providers of multi-channel video programming such as cable TV and direct broadcast satellite (DBS) service, and that any variation from the current policy would put cable TV service at a competitive disadvantage. Adding a new state sales tax on cable TV would double our customers' tax burden as they already shoulder a local gross receipts tax. Likewise, revising Ohio's tax policies in the manner suggested by the DBS industry in testimony in the Senate on HB 64 (131 GA) (*i.e.,* eliminating the sales tax on DBS service) would upend the balance created earlier by the Ohio General Assembly and provide an unfair advantage to one competitor over another.

II. HOW THE MULTICHANNEL VIDEO INDUSTRY IS TAXED IN OHIO

First, I want to review Ohio's current policy on taxing the provision of video service.

A. Cable Taxation

Cable's video product in Ohio is primarily taxed at the local level, although certain parts of the service are also taxed at the state level. In 2007, with the passage of SB 117, the state moved from local franchising to state-issued video service authorizations. Prior to SB 117, a wireline video provider had to obtain a franchise from the local government where it was seeking to provide service. With passage of SB 117, wireline video service providers[1] no longer need a local franchise but must now obtain a video service authorization (VSA) issued by the Ohio Department of Commerce. Commerce also has regulatory authority over wireline video service providers, and these providers must comply with many statutory consumer protection provisions. 1332.26(D) **(Exhibit 1)**

Despite the move to statewide VSAs, the rate of the video service provider (VSP) fee continues to be set by, and remitted to, the local government. Local governmental authorities in Ohio may continue to set the VSP fee at a rate up to five percent of revenue derived from the provision of video service. Additionally, they may elect to include in the calculation revenue from advertising sales, which can drive the effective rate above 5%. In the sample bill attached, the effective rate is 5.26%. **(Exhibit 2)** This fee is unique to the cable industry.

OCTA member companies collect and remit directly to municipalities and townships VSP fees amounting to $78 million annually. Additionally, our customers already pay a state sales tax and the local "piggyback" tax on cable equipment rentals, such as set-top boxes, modems and remotes. Our customers also pay a regulatory fee that is remitted to the Federal Communications Commission. **(See also, Exhibit 2)** To impose a new sales tax on cable service, would more than double the cable customer's tax burden.

Specifically, the VSP fee is levied on the amount of the customer's charges from:

(a) Recurring monthly video service charges;

(b) Event-based charges (*e.g.,* pay-per-view and Video-on-Demand);

(c) Set-top box rentals and other video service equipment fees;

(d) Service charges relating to video service (*e.g.,* activation, installation and repair);

(e) Administrative charges relating to video service (*e.g.*, service order and service termination charges).

(f) Advertising revenues, if a municipality or a township elects to include them.

[1] Video service providers include not only traditional cable companies such as Time Warner Cable, Comcast and Cox, but also telco providers such as AT&T U-Verse and Cincinnati Bell.

O.R.C. Sec. 1332.32(B). **(Exhibit 3)**

These services would **also** be taxed should the sales tax be expanded. Taxing the same service twice is not good policy.

In addition to our VSP fee obligations, the cable industry is responsible for many of the same taxes imposed on general businesses. Additional taxes paid by the industry include, but are not limited to, the Municipal Income Tax, CAT, Real Property Tax, and Sales Tax. The total state and local tax burden of OCTA member companies and their customers is well over $250 million annually, including $78 million paid annually in local VSP fees.

B. DBS Taxation

Cable's biggest video competitor in Ohio is the direct broadcast satellite industry (DBS). Currently, there are over 1.2 million DBS customers in Ohio, making the DBS industry the second largest provider of multi-channel video programming services in the state. Nationally, DBS is larger than every cable operator except for one. It is certainly true that cable and DBS are taxed differently in Ohio: Cable is taxed at the local level via the VSP fee; satellite service is taxed at the state level through the state sales tax.[2] According to testimony presented last year to the General Assembly by the DBS industry, their customers pay over $60 million per year in the sales tax.

C. Federal Preemption

So how did Ohio arrive at this bifurcated tax structure for practically identical products? The disparity stems from Congress' effort to shield DBS providers from the *administrative* burden of filing tax returns with thousands of local governments across the U.S. by preempting local taxation (Section 602 of the Telecommunications Act of 1996)[3]. Congress clearly did not

[2] The current sales tax was imposed on DBS in 2003. At that time, the General Assembly decided not to tax the cable product, recognizing that doing so would amount to double taxation of cable. The DBS industry challenged this tax structure in court, with the Ohio Supreme Court upholding the law as being constitutional. The United States Supreme Court refused to hear the DBS industry appeal. *DIRECTV v. Levin*, 128 Ohio St. 68, 941 N.E.2d 1187 (2010), *cert. denied*, 133 S. Ct. 51, 183 L. Ed. 2d 675, 80 U.S.L.W. 3707 (2012).

[3] Pub. L. No. 104-104, Title VI, § 602 (reprinted at 47 U.S.C. § 152, note)

intend that DBS customers should pay ***less*** tax than cable customers; to that end, Section 602 specifically provides states with the authority to impose a tax on satellite companies and distribute the tax proceeds to local governments if they choose to do so.

The federal preemption precludes DBS paying either the video service provider fee or the local piggyback sales tax that cable customers pay; DBS is also exempted from paying any county imposed Utility Service Tax (UST). Another advantage that DBS has over cable as a result of preemption is that it isn't subject to municipal income taxation. Not only does this save them tax dollars, but it also saves them compliance costs. Our largest member derives less than five percent of its revenue from Ohio, but its tax department spends 20 percent of its time on Ohio municipal tax returns. While HB 5 made improvements to Ohio's municipal tax code, we do not expect our compliance burden to be significantly lessened.

Today, the two DBS providers, Dish and DirecTV, are Fortune 500 companies with about one-third of the market. Recently, DirecTV was acquired by AT&T – hardly a fledgling company. But DBS's local tax preemption remains in place despite the fact that the reason for the preemption (sparing new companies a burdensome tax compliance obligation) has long since expired.

D. Maintain a Fair Tax Structure on Video Services

Understanding that the DBS industry had matured and flourished, the Ohio General Assembly in 2003 equalized the tax laws that had historically favored DBS and its subscribers. The General Assembly, in 2003 and again in 2013 and 2015, recognized that the state was already taxing cable through its local subdivisions and, correctly reading Section 602, determined that the proper taxing jurisdiction for DBS was the state itself. The OCTA has opposed and would continue to oppose any attempt to up-end Ohio's current tax structure, whether by placing the sales tax on cable, or by removing the sales tax on satellite as argued for by DBS during hearings on HB 64. In either case, our tax burdens would cease to be comparable and an advantage would be given to our largest competitor.

Make no mistake, the Video Service Provider Fee and the state sales tax on DBS are both creatures of the Ohio Revised Code, legislated with the knowledge that sound tax policy provides consumers with tax-neutral choices and taxes functionally equivalent services in a similar manner. We would urge this committee to maintain this tax policy goal.

E. Competitive Landscape

Competition throughout the video industry continues to grow. Today, consumers are increasingly obtaining video programming through Internet based providers such as Hulu, Netflix, Amazon, iTunes and other streaming video services (referred to as "over-the-top" or "OTT" video providers). These services are not currently subject to any federal taxes or fees; however, the state now subjects "digital goods" to the sales/use tax. While the imposition of this tax to digital goods amounts to a somewhat comparable tax[4] when compared to what cable customers already bear in the form of the VSP fee, the imposition of a sales tax on cable service will reverse whatever parity was achieved with the taxation of digital goods, thereby keeping cable at a competitive disadvantage against these competitors.

Below is an illustration of the tax disparity the imposition of a sales tax would create between cable, DBS, and OTT providers.

	Cable Television Services	OTT [4]	DBS Services
Sales Tax	6.25%	6.25%	6.25%
Piggyback Sales Tax	Up to 3%	Up to 3%	N/A – federal law
Local VSP Fee	Up to 5+%	N/A	N/A – federal law

The point here is that most cable customers already pay a 5% VSP fee on their cable bill – a fee that neither of our competitors is charged. Imposing another 6.25% state tax, plus the piggyback tax, increases most cable customers' total tax to somewhere between 11 and 14 plus percent. This is just too much. Conversely, if the sales tax is removed from DBS service, cable customers would still be charged the VSP fee, a tax not borne by our competitors. In either case state law would be picking winners and losers through the tax code.

[4] A comparable tax, if it is indeed even collected. Before a vendor must collect the sales tax, nexus to Ohio must exist. Attached is an invoice from one of these vendors for a movie rental on which no state tax is collected, **(Exhibit 4)** which allows this vendor to maintain a price advantage over Ohio VSPs.

III. REGULATORY DISPARITY

Additionally, any discussion of parity in the video industry should also include the disparity between cable and DBS regulation. Under Ohio law, cable operators are regulated by the Ohio Department of Commerce and support its activities financially through an annual assessment, are subject to consumer protection statutes, and are required to set aside prime channel space for public, educational, and government access channels – NONE of these state imposed burdens are applicable to DBS. At the federal level, DBS operators are treated more leniently than cable in a number of respects. In any discussion of parity in state burdens imposed on the video industry, the imbalance of regulatory burdens should also be considered.

IV. CHANGES TO THE TAX STRUCTURE WILL SLOW CABLE'S DEPLOYMENT OF ADVANCED SERVICES

Federal, state and local policymakers have all recognized the importance of broadband technology to our economy. They also know how critical it is to the rural Ohio economy that these areas stay on the cutting edge of information technology.

Ohio cable operators have invested over $1.2 billion in private capital in just the past three years to upgrade infrastructure, providing residential and business customers with advanced services. Many companies have also expanded their competitive offerings to include business and residential telephone services, providing meaningful competition to the local telephone company.

Ohio's tax policy should not stifle the cable industry's ability to create and offer new and improved digital services to business and residential consumers. Ohio's stated policy goal is for the expansion of broadband access (O.R.C. 1332.22), and its tax policy should support that goal.

V. ARGUMENTS WITHOUT GROUNDS

A. The State Imposed VSP Fee is not "rent" to Local Government

Our competitors in the past have relied upon the canard that the state VSP fee is somehow "rent" paid to local government for the use of the rights-of-way (ROW). However, the VSP fees are not rent to occupy the ROW; the VSP fees are not based upon the cost to occupy the ROW as is required under Ohio law[5] for municipal ROW charges – instead, VSP fees are based on a percentage of the customers' bills on items that have nothing to do with the ROW. ROW fees are required to be maintained in a special fund, but VSP fees go to the general fund to be used for any purpose. Further, if the VSP fee was for the cost of occupying the rights-of-way, then all occupiers would pay this fee, but the VSP fee is unique to cable.

Even the courts have rejected arguments that fees like the VSP fee are "merely rent" for using "public spaces," holding instead that "franchise fees and related obligations are … *not* rent payments, but rather statutorily authorized tax payments." *DIRECTV, LLC v. Dep't. of Revenue*, 470 Mass. 647, 656, 2014 WL 7883570 at *5 (Mass. Feb. 18, 2015) *cert. denied*, 136 S.Ct. 401, __U.S. __ (2015) ("*Massachusetts DBS Tax Case*") (emphasis added).[6]

B. Accounting Entries are Irrelevant to Tax Policy

DBS also mistakenly characterizes cable operators' franchise agreements, or, in Ohio's case Video Service Authorizations, as valuable "assets" based upon their mistaken read of certain federally mandated filings. The accounting treatment of the massive investment by cable operators in their plant and equipment must appear on a balance sheet in some form as an asset, but bear in mind the right to provide service under the VSA is non-exclusive, subject to competition from DBS and telephone companies. DBS's citations to cable companies' annual reports show that "assets" are accounting entries derived from acquisitions and that, unlike any traditional "asset," are neither depreciated nor amortized. A review of two DBS annual reports shows identical treatment of the DBS providers' FCC satellite licenses. These are not "rent" for the orbital slots where their satellites are parked (indeed, DBS occupies these invaluable slots for free) but reflect acquisitions, infinite life, and goodwill. All in all, accounting entries like these have absolutely no bearing on the propriety of a tax policy.

[5] Ohio Revised Code Chapter 4939.

[6] In upholding the DBS excise tax in Massachusetts that did not apply to cable, the Supreme Judicial Court "follow[ed] the other courts that have considered and rejected the satellite companies' challenges to the laws of other States," and cited with approval the decision upholding the DBS sales tax here in Ohio. *DIRECTV, LLC v. Dep't. of Revenue*, 2014 WL 7883570 at *5, citing *DIRECTV v. Levin*, 128 Ohio St.3d 68, 941 N.E.2d 1187 (2010), *cert. denied*, 133 S. Ct. 51 (2012).

C. **<u>DBS Imposes Burdens on State and Local Governments and Should Support the Government through Some Taxation</u>**

DBS operators have also misleadingly suggested that their own signals are delivered from satellites to customers without imposing *any* burden on the state or its municipalities, and, therefore, they should not be subject to state taxation. But DBS fails to note the many and varied ways in which their facilities are actually present in, and impose a burden upon, local communities. For example:

- DBS operators maintain extensive networks of local retailers and installers that must deliver and install specialized receiving equipment to enable DBS subscribers to receive satellite transmissions.

- Likewise, DBS operators, just like their cable competitors, must establish local antennae to receive the signals of local broadcast television stations and then distribute them to their subscribers. Those signals are obtained either by direct fiber optic links (consisting of fiber optic cables deployed on utility poles or in underground conduits) or over-the-air links between the DBS operators' satellite uplink sites and the broadcast television stations' studios.

Thus, while DBS uses a different ultimate delivery system than cable television, its local activities throughout Ohio all impose physical and regulatory burdens on the state and its communities. As with any business operating in Ohio, DBS should support the local and state government which creates and maintains the infrastructure for business to compete and thrive through paying its fair share of taxes.

D. **<u>Ohio's Cogent Tax Policy is not an Outlier</u>**

DBS has also argued that Ohio is somehow an "outlier" in its treatment of taxing these two competitors. But that is simply not the case. At least twelve states, including our neighbor Kentucky, have in some way enacted laws in an attempt to bring parity to the taxation between these video service providers.

There is simply no reason to up-end Ohio's constitutional tax structure in favor of a tax structure that favors one product over competitors' products.

VI. CONCLUSION

For more than 50 years, Ohio's cable industry has invested in Ohio – providing employment to Ohioans, becoming an integral part of our communities, constantly upgrading embedded infrastructure to provide video service, high speed internet, and telephony to our customers – who already pay their fair share in state and local taxes. The taxes paid by our industry in Ohio, and by our customers, have provided billions of dollars in revenue to local governments throughout the state.

Imposing a state sales tax on cable TV would penalize our industry and double the tax burden on our customers, while benefiting our competitors. Eliminating the sales tax on our competitors, while maintaining the VSP fee on cable, would also disrupt the competitive balance Ohio's current tax policy provides. Any change to the current tax policy could force customers to downgrade or drop cable service altogether, which will result in declining revenues for cable operators and declining VSP fee-collections for municipalities. Hardest hit would be independent cable operators serving our more rural communities. Our industry's continued aggressive deployment of advanced services, and the livelihoods of cable industry workers, would be threatened.

I respectfully urge you to follow the lead of past General Assemblies and this General Assembly in maintaining Ohio's current, sound tax policy as it regards the provision of multi-channel video service; Ohio's current policy provides a fair tax structure that does not favor one competitor over another. Thank you again for the opportunity to testify before you today. I'd be happy to answer any questions you may have.

1332.26 Political subdivision authority - complaints - standards.

(A) No political subdivision shall require a video service provider to obtain from it any authority to provide video service within its boundaries.

(B) Except as authorized under division (C) of this section and under sections 1332.30 and 1332.32 of the Revised Code, no political subdivision shall request anything of value from a video service provider for providing video service; impose any fee, license, or gross receipt tax on the provision of video service by such a provider; or impose any franchise or other requirement on the provision of video service by a video service provider, including, but not limited to, any provision regulating rates charged by a video service provider or establishing any build-out requirement or requirement to deploy any facility or equipment.

(C) When requested to do so, a video service provider shall assist a municipal corporation or township in addressing video service subscriber complaints, in a manner consistent with the provider's complaint handling process set forth in its application pursuant to division (A)(7) of section 1332.24 of the Revised Code. Nothing in sections 1332.21 to 1332.34 of the Revised Code affects any authority granted under sections 1345.01 to 1345.13 of the Revised Code.

(D) A video service provider shall meet all of the following customer service standards:

(1) The provider shall restore video service within seventy-two hours after a subscriber reports a service interruption or other problem if the cause was not a natural disaster.

(2) Upon a report by a subscriber of a service interruption and if the interruption is caused by the video service provider and lasts for more than fours hours in a given day, the provider shall give the subscriber a credit in the amount of the cost of each such day's video service as would be billed to the subscriber.

(3) Upon a report by a subscriber of a service interruption and if the interruption is not caused by the video service provider and lasts for more than twenty-four consecutive hours, the provider shall give the subscriber, for each hour of service interruption, a credit in the amount of the cost of per hour video service as would be billed to the subscriber.

(4) The provider shall give a subscriber at least thirty days' advance, written notice before removing a channel from the provider's video service, but no such notice is required if the provider must remove the channel because of circumstances beyond its control.

(5) The provider shall give a subscriber at least ten days' advance, written notice of a disconnection of all or part of the subscriber's video service, except if the disconnection has been requested by the subscriber, is necessary to prevent theft of video service, or is necessary to reduce or prevent signal leakage as described in 47 C.F.R. 76.611.

(6) The provider shall not disconnect all or part of a subscriber's video service for failure of the subscriber to pay its video service bill, until the bill is at least forty-five days past due.

(7) The provider shall give a subscriber at least thirty days' advance, written notice before instituting an increase in video service rates.

Effective Date: 2007 SB117 09-24-2007

Exhibit 2

Time Warner Cable

[redacted]
Total due on Feb 28, 2015: $137.44
Account number [redacted]
Customer code [redacted]
Statement date Feb 04, 2015

	Previous Balance	
	Balance last statement	134.02
	Total previous balance	**134.02**
	Payments	
01/08	Payment received	-134.02
	Total payments	**-134.02**
	Monthly services	
02/03-03/02	Starter TV	22.99
	Standard TV	55.00
	Starz	12.99
	Variety Pass	9.05
	HD-DVR Set-Top Box	11.25
	DVR Service	12.99
	Total monthly services	**124.27**
	Basic tier (Starter TV) may be purchased by itself for $22.99 per month	
	Taxes, fees & surcharges	
	Broadcast TV and Sports Programming Surcharges	5.50
	Franchise Fees	6.83
	State Sales Tax	0.76
	FCC Regulatory Fee	0.08
	Total taxes, fees & surcharges	**13.17**
	Total due on Feb 28, 2015	**137.44**

Reach us at your convenience

In person
1135 S. Main St. Suite 210, Bowling Green, OH 43402
Monday-Friday 8:30am-5:30pm
Closed Saturday

On twc.com
Visit twc.com/account to pay your bill online, view FAQs/self-help options and chat with live agent. Just have your customer code above on hand.

Through your mobile device
With our free My TWC® app.

Over the phone
Call us anytime at 1-800-TWCABLE to speak to someone live with any questions about your bill.

Pay online

Go green with online bill payment.
Sign up at **twc.com/account**
Have your account number and customer code ready, found on the top of this page.

Pay by phone

Call us anytime at **1-800-TWCABLE**, simply say "pay my bill" to pay your bill for free. Or you can speak to someone live with any questions about your bill.

Customer information

Experiencing technical issues with closed captioning? Call 1-866-892-4249, email closedcaption@twcable.com, or fax 1-877-430-1386. Address written complaints to A. Long, Legal, 13820 Sunrise Valley Dr., Herndon, VA 20171, email twc.closedcaptioningissues@twcable.com, or fax 1-704-697-4935. To follow up on a written submission, call 1-877-276-7432.

If your check is returned, you expressly authorize your bank account to be electronically debited for the amount of the check plus any applicable fees. The use of a check for payment is your acknowledgement and acceptance of this policy and its terms and conditions.

To view the call detail for your Home Phone calls, go to twc.com/account

For Information on any upcoming programming changes: Please consult the Legal Notices published in the Toledo Blade on the 1st and 3rd Wednesday of each month or on twc.com

Visit twc.com/careers for career opportunities at Time Warner Cable.

TWC imposes surcharges to recover costs of complying with its governmental obligations.

Franchising Authority FCC ID#OH0139
Bowling Green City, 304 N Church St Bowling Green, OH 43402

Exhibit 3

1332.32 Payment of video service provider fees.

(A) Not sooner than forty-five nor later than sixty days after the end of each calendar quarter, a video service provider shall pay a video service provider fee to each municipal corporation and each township in which it offers video service. The fee shall be calculated quarterly by determining the provider's gross revenue for the preceding calendar quarter as described in division (B) of this section and multiplying the result by the percentage specified in division (C)(1)(a) or (b) of this section.

(B) Gross revenue shall be computed in accordance with generally accepted accounting principles.

(1) Gross revenue shall consist of all of the following revenue for the calendar quarter that is collected by the provider for video service from all its subscribers having service addresses within the municipal corporation or, respectively, the unincorporated area of the township:

(a)Recurring monthly charges for video service;

(b) Event-based charges for video service, including, but not limited to, pay-per-view and video-on-demand charges;

(c) Charges for rental of set top boxes and other video service equipment;

(d) Service charges related to the provision of video service, including, but not limited to, activation, installation, and repair;

(e) Administrative charges related to the provision of video service, including, but not limited to, service order and service termination charges.

(2) Gross revenue shall not include any of the following:

(g) Advertising revenue, unless a municipal corporation enacts an ordinance or a board of township trustees adopts a resolution that uniformly applies to all video service providers. For those purposes, "advertising revenue" means the net revenue received by the video service provider for advertising on its subscription-based video service within a municipal corporation or the unincorporated area of a township. If such revenue is derived under a regional or national compensation contract or arrangement between the video service provider and one or more advertisers or advertising representatives, the amount of revenue derived for a municipal corporation or for the unincorporated area of a township shall be determined by multiplying the total net revenue received by the video service provider under the contract or arrangement by the percentage resulting from dividing the number of subscribers in the municipal corporation or unincorporated area of a township by the total number of regional or national subscribers that potentially receive the advertising under the contract or arrangement. The municipal corporation or township shall promptly notify affected video service providers of the ordinance or resolution, which shall not take effect until the first day of the first calendar quarter that begins more than thirty days after the notice.

Exhibit 4

amazon.com

Details for Order #[redacted]

Print this page for your records.

Amazon.com order number: [redacted]

Order Total: $14.99

Digital Order: December 31, 2014

Items Ordered	Price
Gone Girl [HD] [Amazon Instant Video] By: David Fincher, Ben Affleck, Rosamund Pike ... Sold By: Amazon Digital Services, Inc.	$14.99

Item(s) Subtotal: $14.99

Total Before Tax: $14.99

Tax Collected: $0.00

Total for this Order: $14.99

Payment Information

Payment Method

VISA | Last 4 digits: [redacted]

Billing Address

[redacted]

WORTHINGTON, OHIO [redacted]

[redacted]

Item(s) Subtotal: $14.99

Total Before Tax: $14.99

Tax Collected: $0.00

Grand Total: $14.99

Return to the Order Summary.

Please note: This is not a VAT invoice.

BEFORE THE 2020 TAX POLICY STUDY COMMISSION
PERSPECTIVES ON AND RECOMMENDATIONS FOR
IMPROVING OHIO'S STATE & LOCAL TAX SYSTEM
MONDAY – JUNE 20, 2016

Co-Chairmen Senator Peterson and Representative Schaffer and Members of the Commission,

My name is Daniel Navin and I am the assistant vice president of tax & economic policy for the Ohio Chamber of Commerce. I thank you for the opportunity to present to the commission our views on Ohio's existing tax system and structure and some recommendations for its reform and improvement. Joining me today are the Chairman of the Ohio Chamber's Taxation & Public Expenditures Committee Jim Seiwert, Global Director of Grants and Incentives for Owens-Illinois Corporation; and the Chairman of the Ohio Chamber's Board of Directors Tom Zaino, Managing Member of the law firm Zaino Hall & Farrin LLC, who is also a member of the Chamber's Tax Committee.

Even though the Ohio Chamber has given specific testimony to the Commission back in February on tax expenditures, Mr. Seiwert will expand upon our initial comments and outline how those issues are viewed from a company and business perspective. Thereafter, Mr. Zaino will touch on the Chamber's point of view and ideas in several major tax policy areas, including municipal income tax, the taxation of pass-through entities and their owners, and the commercial activity tax. I will then conclude with some thoughts on the severance tax and more expansively on sales & use tax, particularly the need to repeal the sales tax on employment services and our call for an in-depth examination among the business community and the Department of Taxation in the area of what should and should not be taxed as an electronic information service, including automatic data processing and computer services.

But first, I want to make some preliminary comments on the general subject of Ohio's tax competitiveness, a subject Mr. Seiwert will also tackle. The Ohio Chamber has been a significant contributor to a number of the most important reforms of Ohio's tax structure over the years – updating the "primarily used in manufacturing" sales tax exemption; revising the net worth base and ultimately repealing the corporation franchise tax; reducing the assessment percentage and eventually eliminating the tangible personal property tax on machinery & equipment, furniture & fixtures and inventory; twice enacting reforms of the municipal income tax; and, eliminating the estate tax, to name a few.

When added to the reductions in state personal income tax rates since 2005 the General Assembly and the Taft and Kasich administrations have spearheaded and enacted, Ohio is now in an excellent position to capitalize on our relatively competitive tax structure. That's not to say we should stand pat and not continue trying to reduce PIT rates even further. It is to say, however, Ohio is in a relatively good place after all the recent reforms and we should not undermine those efforts by doing other things that increase the cost of doing business in this state.

This leads to a point or principle our Ohio Chamber business members have adhered to in the past and our Tax Committee that decides our position on tax-related legislation want me to reiterate to the Commission – that is, we continue to believe, and several recent studies back up this conclusion, that it is counter-productive and anti-competitive, particularly for Ohio manufacturers, to expand the sales tax base to include more business input purchases of services.

For some time now, one of the justifications put forward for expanding the base of the sales tax to various services purchased by businesses from businesses (B2B) has been that Ohio should shift away from income taxes to so-called "consumption" taxes. In this context, the term "taxing consumption" is intended to mean subjecting to sales tax many or all of the services sold/purchased within the state's economy which, it has been asserted, comprises up to two-thirds of Ohio's gross state product. The implication is that many parts of the service sector of the economy, because they are not subject to a sales tax of 6 to 8 percent of the transaction price, are unfairly not paying enough tax to the state.

What is not said is contained in the first paragraph (page 24) of the EY Report on HB 64 we submitted to the House and Senate in March 2015, where it says,

> **"Expansion of the sales tax to include new categories of business and professional services (as well as consumer services) has implications that are quite similar to those of a gross receipts tax, though with a much narrower base. Such expansion runs contrary to the basic economic premise of the general retail sales tax as a tax on final consumption. Many of the undesirable**

outcomes that occur from increased Commercial Activity Tax (CAT) rates are possible from taxing business services depending upon the extent to which taxed services are used across different sectors and the number of stages that such services appear in the supply chain of a particular product or service."

In other words, subjecting business and professional services to sales tax should not be thought of as a tax on final consumption, but rather as a pyramiding tax on production/manufacturing and distribution, which are very significant components of our state's economy. In fact, that last sentence in the quote understates the potential negative consequences of subjecting services to sales tax, as the sales tax rate of six to eight percent per transaction is much higher than the CAT rate and thus is much more damaging to Ohio manufacturing and industrial businesses, particularly if much of the market for their products is out-of-state.

Take the example of "management consulting services", defined as any activity that provides advice and assistance to businesses and other organizations on business issues, that would have become subject to sales tax in HB 64, including:

- **Financial planning and budgeting**
- **Equity and asset management**
- **Records management**
- **Office planning**
- **Strategic and organizational planning**
- **Site selection**
- **New business startup**
- **Business process improvement**
- **Human resource management**
- **Marketing issues and planning**
- **New product development**
- **Pricing strategies**
- **Licensing and franchise planning**
- **Manufacturing operations improvement**
- **Productivity improvement**
- **Production planning and control**
- **Quality assurance and control**
- **Inventory management**
- **Distribution and warehouse operations**
- **Materials management and handling**
- **Telecommunications management**
- **Utilities management.**

That's 22 separate expenses that are commonplace across most Ohio companies' operations. Virtually every facet of a business that a company's management either provides in-house or contracts for with an outside provider would have become subject to sales tax. As noted on page 26 in the EY study I referred to earlier in my remarks, it says,

> **"For Ohio firms that produce for sale in markets outside of Ohio, this additional embedded tax will place them at a competitive disadvantage with competing, non-Ohio firms. Firms producing in this environment will be required to absorb most of the economic burden of the tax. Ohio firms producing for national or local markets will have incentives to purchase from out-of-state suppliers to reduce the level of embedded tax. This will force local, Ohio suppliers to reduce prices and absorb the tax."**

This summarizes why the Ohio Chamber strongly believes imposing sales tax on these B2B services would make Ohio businesses less competitive and thus should not be part of any income tax reduction package. I would also urge the committee to review the Council On State Taxation (COST) April 4, 2013 study entitled, *What's Wrong with Taxing Business Services? Adverse Effects From Existing and Proposed Sales Taxation of Business Investment and Services*.

I will now turn it over to Jim Seiwert.

<u>JIM SEIWERT</u>

<u>Tax Credits and Tax Expenditures</u>

Co-Chairmen Senator Peterson and Representative Schaffer and other Members of the 2020 Tax Policy Study Commission,

My name is James Seiwert and I'm Global Director, Grants & Incentives for Owens-Illinois, Inc. and its subsidiaries. I'm also Chairman of the Ohio Chamber of Commerce Tax Committee. I'm an Ohio Certified Public Accountant and I've worked with Ohio tax issues for over 30 years.

Owens-Illinois, Inc., or O-I, is headquartered in Perrysburg, Ohio. O-I is the largest manufacturer of glass containers in North America. O-I has a large glass manufacturing plant in Zanesville and O-I's corporate offices are in Perrysburg along with R&D facilities and a new Innovation Center that opened in 2013.

Thank you for allowing me to present testimony today to assist you with your review of Ohio's tax structures and tax policies. I'll begin with some brief comments about Ohio's tax structure and issues from an O-I perspective. I'll then discuss Ohio's tax credits and compare to some other states' tax structures, so you can make recommendations on how to maximize Ohio's competitiveness.

During the past ten years, Ohio's tax structure has been incrementally improved many times. The personal income tax rate has been significantly reduced, the corporate franchise tax was eliminated, the personal property tax was eliminated for most businesses, and the municipal income taxation of businesses has been improved. But, to offset these reductions and eliminations, Ohio created the Commercial Activity Tax. As a result, Ohio's tax structure is much different from most other states.

As I said, O-I is based in Ohio and we work with Ohio's tax structure on a daily basis. O-I's Ohio net business taxes are similar to the other states where O-I's plants are located. However, Ohio's personal income taxes, when combined with the municipal income taxes, do not compare favorably with many of O-I's other states.

O-I regularly hires new employees in Ohio at its corporate headquarters and R&D facility. Many of these new employees relocate from outside Ohio. When these employees receive their first paycheck, the municipal income tax becomes an obvious additional deduction from their take home pay. The municipal tax is one area where Ohio is not competitive with other states.

When we analyze state taxes for a site location analysis, we estimate all of the state's business taxes and we look for all possible tax credits and other incentives we can obtain for bringing jobs and investment to the state. States with a personal property tax usually offer a multi-year, partial tax abatement for the new investment. Some states offer cash grants based on a percentage of the new jobs and investment amounts. Some states offer sales tax credits and training credits. Over multiple years, these types of incentives can become significant amounts.

The number of Ohio's business credits has been reduced as a result of eliminating the corporate franchise tax and the personal property tax. Now, the primary business tax credits are deducted from the Commercial Activity Tax. For a business locating in Ohio, Ohio has the Job Creation Tax Credit, Job Retention Tax Credit, Credit for Research & Development Expenses and the Research & Development Loan Program Credit. Over multiple years, these Ohio credits can be significant, but if not refundable, they must be offset against the Commercial Activity Tax.

Tax credits may not be the deciding factor in an investment or job creation decision, but their value is definitely factored into the cost of capital and the costs for a plant. O-I must compete with other glass packaging companies in other states. If our competitor receives a tax credit or tax incentive in their state, their cost of capital is reduced. O-I is at a disadvantage if we do not receive a credit or incentive to help offset our cost of capital, assuming the overall taxes are similar. When management hears that a competitor received an incentive, they want to know why our plant didn't receive any assistance.

O-I's manufacturing plants around the world need to have their furnaces re-bricked about every 10 to 15 years. In addition, the plants need updated, or new, equipment to manufacture glass containers with the latest technology. These are expensive capital improvements and the plants must compete against one another for O-I's limited capital spending dollars.

Many factors determine which plants receive the capital dollars, but incentives are one of the factors that can offset the cost of capital and the payback period. Consequently, incentives can make a difference in when and if capital spending is approved for a plant.

Glass packaging must compete with other packaging options such as aluminum cans and plastic bottles. Consequently, price is a significant issue for glass packaging. Profit margins for glass are low, so a plant that cannot control its costs is under constant pressure to improve. Although tax incentives only offset a small part of a plant's costs, the credit or incentive can be the difference between a profit or a loss. Every plant considers these incentives important to their cost structure.

These issues should be considered as the Commission reviews and evaluates all tax credits authorized by the state. A tax credit can be thought of as an up-front investment in order to obtain long-term benefits and returns. A tax credit can generate new or increased payroll withholding taxes, property taxes and sales taxes. The total economic impact of the tax credit is important to evaluate.

As the Commission reviews the tax credits, keep in mind that taxpayers made decisions based on the law as it is written. To change the law after a taxpayer has made an investment, hired employees or otherwise made the decision to stay in Ohio, can be detrimental and costly to the taxpayer.

In closing, for Owens-Illinois, the Ohio tax structure as it is today is different from, but compares favorably with, other states where O-I does business. However, as you evaluate ways to make Ohio's tax structure more competitive, please be careful not to mistake increasing taxes on business as a way for Ohio to be more competitive.

Thank you for your attention and interest and good luck with your review of Ohio's tax structure. I now turn it over to Tom Zaino.

TOM ZAINO

Co-Chairmen Peterson and Schaffer and other members of the 2020 Tax Reform Committee,

I am Tom Zaino. I serve as Chair of the Ohio Chamber of Commerce's Board of Directors. I also serve as managing member of Zaino Hall & Farrin LLC, a boutique law firm located here in Columbus.

Our firm works everyday with companies and individual taxpayers that are under audit by the Ohio Department of Taxation or by Ohio municipalities. As Mr. Navin and Mr. Seiwert mentioned in their testimony, Ohio has made great strides over the last decade to reduce the negative impacts of Ohio's tax system, including the personal income tax imposed on business income. However, although not as popular to talk about as the personal income tax, many areas of Ohio's tax system continues to be anticompetitive and create hurdles to job creation and investment in our state. I will highlight some of these hurdles. The Ohio Chamber of Commerce is willing to work with the Committee to discuss these items in more detail and to identify ways to eliminate these hurdles.

Municipal Income Tax

As you are fully aware, Ohio recently made great strides to impose greater uniformity and simplicity on the Ohio municipal income tax system. In spite of these important improvements, Ohio's municipal income tax system still remains the most anticompetitive local income tax system in the country. The anticompetitive aspects of the system are not so much focused on the amount of the tax, although this is certainly a concern as local taxes have increased. Instead, the Chamber is concerned about the high cost of compliance and double taxation that occurs.

The easiest and most efficient way to reduce the compliance costs would be to require centralized reporting and collection of municipal income tax. Centralization would not only benefit business, but also benefit municipalities by lowering the cost of administration. The Chamber asks the Committee to consider a creative option to address this issue. In the past, municipalities have been suspect of

any effort by the state to administer local taxes.1 But, we suggest the Committee consider a different option. Under R.C. 167.01, a statewide Council of Governments could be created by the municipalities to administer their own municipal tax systems.

Before assuming that Ohio's municipalities would never agree to do such a thing, please know that they already have done this. The Regional Income Tax Authority (RITA) is a Council of Governments formed under this provision.2 RITA administers the municipal tax systems for about forty percent (40%) of Ohio's municipalities.3 Imagine for a moment how this would benefit municipalities – only requiring one computer system; being able to obtain IRS data to verify compliance; elimination of overlapping roles, enabling municipalities to reduce payroll and save taxpayers significant dollars; such a centralized group would be run by the municipalities and for the municipalities—no state involvement would be necessary.4 The municipal cost savings could be used to pay for vital local government services or could be returned to taxpayers. If this centralized administration is good enough for over 250 municipalities, why is it not good enough for all municipalities?

Another anti-competitive aspect of the municipal income tax system is the "throwback rule." A business that ships goods from an Ohio warehouse located in an Ohio city to another state must treat those as sales in the Ohio city unless an employee (not a contract salesperson, not an affiliate's salesperson, etc.) of the taxpayer actually solicits the sales at the location to where the goods are shipped. This rule is simply a tax grab by municipalities on unsuspecting taxpayers and has no tax policy rationale or benefit.

Finally, one extra cost whey trying to attract talent is the municipal tax system. For instance, workers relocating to Ohio are usually surprised by the double taxation that occurs between cities. The cause of this is that municipalities are not required to provide a credit for taxes paid to an employee's work city. The way to fix this impediment is to require each resident's municipality to provide a 100% credit for taxes paid to the resident's work municipality.

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[1] Note: In 2003, the tax commissioner began administering the municipal income tax on telephone and electric companies. The tax commissioner also administers the school district income tax.

[2] RITA was formed around 1971 under the aegis of the Regional Council of Governments, which was established under R.C. 167.01. RITA acts as the tax administrator of member municipalities in the administration, enforcement, and collection of taxes imposed by the member municipalities.

3 Source: RITA's website – https://www.ritaohio.com/about/

4 Observation: State level administrative expenditures rank as 30th highest compared to other states. However, Ohio's state and local administrative expenditures rank 19th highest in the country. Source: Deputy Secretary Mark Muchow, West Virginia Department of Revenue, based on 2013 data.

Pass-Through Entity Taxation

The current Pass-Through Entity (PTE) Tax in Ohio is a stand-alone tax which is imposed on pass-through entities.5 It is imposed in order to ensure personal income tax is paid by non-resident individual owners of such entities for the Ohio-sourced income earned by such entities. The PTE Tax generally is equivalent to the owners' personal income tax liability. Therefore, when the non-resident owner files his or her own personal income tax return, such owner can claim a credit for the PTE Tax paid on the owner's behalf.

However, the PTE Tax does not operate appropriately when a pass-through entity is indirectly owned by a corporation (which is not subject to the personal income tax). The indirectly-owned PTE must essentially remit PTE Tax for the corporation's share of the PTE's income, but no mechanism exists for the corporation, which is not subject to the personal income tax, to obtain a refund of the PTE tax paid on the corporation's share of the income.

S.B. 288 is currently pending in the Senate and proposes several tax law changes. The Chamber believes the proposals in that bill which relate to the PTE Tax are generally a step in the right direction to address these concerns.

Commercial Activity Tax

The Commercial Activity Tax (CAT) first became effective on July 1, 2005 and the rate was phased in over the following five (5) years. The full rate of 0.0026 was fully phased in by July 1, 2010. After 10 years, the CAT continues to remain a competitive, stable, equitable, and simple tax. However, the pyramiding that occurs and the nature of a gross receipts-measured tax can be a significant disadvantage. These potential problems have been mitigated by keeping the base broad and the rate low. Changes to the rate, whether to increase it or to establish different rates for different industries, would quickly convert the CAT into an uncompetitive tax.

The Chamber urges that the CAT rate stay unchanged (neither increased nor decreased) and be applied across the board to all CAT taxpayers. Further, the Ohio Chamber also supports keeping the CAT a broad based tax, with any exclusions and exemptions primarily focused on addressing Constitutional or competitiveness issues.

5 A pass-through entity is generally a partnership, S corporation, or limited liability partnership. Also, limited liability corporations are generally treated as partnerships or S corporations.

Next, Dan Navin of the Ohio Chamber of Commerce will discuss some uncompetitive aspects of the sales and use tax, as well as wrap up our testimony.

DAN NAVIN

Severance Tax

No industry likes to be targeted for paying higher taxes that would benefit a different segment of taxpayers. That is a precedent that we at the Ohio Chamber, who count all sizes of companies and industries among our membership and thus represent their interests at the Statehouse, do not want to have established in Ohio. We believe the primary purpose of the severance tax is to sufficiently fund the Ohio Department of Natural Resources in order maintain its program of regulating the industry. The current tax, as a volume-based tax and not subject to the vagaries of global oil prices, is working as intended. It also generates a consistent, predictable stream of revenue.

All of you know that the Utica Shale play in particular represents tremendous growth potential for an area of the state that has long been economically depressed. We would urge that you not make any recommendations that would constrict the economic opportunity for that part of the state by significantly increasing taxes on the industry.

Sales Tax on the Purchase of Employment Services

A key priority of the Ohio Chamber's tax policy agenda for this legislative session is the repeal of this tax. In December 1992, the General Assembly passed HB 904 to address a looming budget gap and made the purchase of an employment service subject to sales tax. Nearly six months thereafter, the legislature established several exclusions from the tax. However, due to both narrow interpretations of the statutory language and genuine difficulties in applying the tax, business taxpayers still have significant concerns about both the fairness and perceived expansion of the tax.

The first major issue with the tax is that it is imposed not just on the fee of the service provider, but also on the wages of the person "hired". There are 11 states that impose a tax of some kind of employment services. In five of those states (DE, HI, NM, SD, WA) the tax imposed is more of a gross receipts tax, similar to Ohio's CAT, but not a sales tax on the purchase of employment services as a transaction. The other six states (CT, DC, IA, OH, PA, WV) do impose a sales tax on

employment services, ranging from five to six percent at the state level. But Ohio is the only state that subjects the hired person's wages/compensation to sales tax also.

Second, vague or unclear statutory language in some instances and lack of available guidance in others, have led to taxpayers and the Department of Taxation (ODT) having good faith but fundamental disagreements about the application and interpretation of the tax in a number of situations. The issues are many and varied, such as the requirement to qualify for exemption that the personnel "perform work or labor under the supervision or control of another" and the difficulty of making that determination; or the "contract of more than one year" requirement; or the "permanent assignment" requirement; or ODT's position that if there is one employee provided under the contract that is not permanently assigned (one bad apple), the entire contract and all the personnel hired thereunder fails to qualify for exemption.

Many of these issues are very fact and circumstance specific and thus is a major reason why this area is one of the largest categories of audits for ODT. In addition, many services traditionally considered to be exempt from sales tax, such as information technology, engineering, accounting and tax services, are being captured as "employment services" and therefore are being taxed. For all of these reasons, the Ohio Chamber believes the employment services tax must be substantially revised statutorily, if not outright repealed.

Sales Tax on Electronic Information Services

Not unlike the sales tax on employment services, determining from the point of view of a business taxpayer whether sales tax should apply to the purchase of an electronic information service really begs the question – that is, what is a taxable electronic information service under the rapidly developing and changing world of technology and the electronic transmission/transfer of information. The legislature in the last few months got a bird's eye view of the difficulty in this area of tax law with the passage of HB 466, the legislation that precluded digital advertising from being subject to sales tax as an electronic information service.

In fact, in December 2015, ODT updated its 1999 information release regarding On-line services and Internet Access and has essentially newly interpreted various subscription services, on-line chat features, mass e-mails, and credit rating services and reports as taxable electronic information services. This has been done without obtaining input from taxpayers and without submitting the revised information release through the Joint Committee on Agency Rule Review (JCARR) process.

The Ohio Chamber simply believes this area of tax law, electronic information services, needs to go through a similar review to what was done with the manufacturing exemption back in the late 1980s and early 1990s. This process should involve the business community, the legislature and ODT sitting down and painstakingly analyzing different situations or fact patterns involving business purchases of electronic information services and whether each one should be deemed taxable or non-taxable. This negotiating process would be in-depth and under the supervision of legislative leaders, with a date certain for a final report.

Co-Chairmen Senator Peterson and Representative Schaffer, that completes our testimony and we would be happy to respond to any questions the Commission members may have.

Written Testimony
The Ohio Society of CPAs
For
The Ohio 2020 Tax Policy Study Commission
June 20, 2016

Co-Chairmen Peterson and Schaffer, Director Keen, and members of the Ohio 2020 Tax Policy Study Commission, thank you for this opportunity to share The Ohio Society of CPAs (OSCPA) written testimony on our white paper report, "Driving a Pro-Business Tax Environment" issued by the Ohio Tax Reform Task Force. The report can be downloaded at www.ohiocpa.com. I'm J. Matthew Yuskewich, CPA, and I served as the Chair of the Task Force, comprised of 19 tax professionals throughout Ohio with a broad range of expertise. OSCPA is a community of 22,000 members representing 85,000 CPAs and accounting professionals statewide, leading important initiatives that protect the public and create a healthy and sustainable business climate in Ohio.

Five elements are widely accepted as key tenets of a quality tax system: *competitiveness, simplicity, stability, equity/fairness and neutrality*. These principles of a quality tax system provide the basic standard for the consideration of reforming and modernizing Ohio's tax laws and each factor should be a key element as elected officials and other policymakers consider how best to design our state's tax structure for the future. Ohio's current tax climate is certainly better than where we were in 2010. Turning back to a focus on taxation, after careful evaluation by our Task Force and emphasizing the five elements of good tax policy, this white paper outlines OSCPA's recommendations on each of the major forms of state and local taxation, and additional insights for consideration.

PERSONAL INCOME TAX

There are two main factors to consider with personal income tax: the tax rate itself, and the system used to collect revenue from taxpayers which includes allowable credits and deductions.

In 2015, forty-three states levied an individual income tax. Of those, forty-one states taxed wages and salary income, and two states exclusively taxed dividend and investment income. Of those states taxing wages, eight have a flat-tax structure whereby a single rate applies to all taxable income, including three of Ohio's neighbors (Indiana, Pennsylvania and Michigan). Thirty-three states have a multi-bracketed system, ranging from as few as two rates to as many as ten brackets. Ohio's graduated personal income tax system is on the high end with **nine** income tax brackets. The Task Force believes a straightforward, simple tax system with optimally three but no more than five brackets as opposed to the current nine brackets is even more beneficial. Reducing the number of brackets should bring greater simplicity to the personal income tax structure.

Flat Tax Considerations:

There is no doubt that having a single income tax bracket is even simpler than having three to five brackets. However, if pursued, moving to a flat tax in Ohio should be done with an acute awareness of the realities of the situation, and the strong likelihood of the financial challenges it will cause, especially during an economic downturn. OSCPA has previously expressed significant concern about efforts to pay for a lower personal income tax rate by raising other taxes paid by business owners (CAT rate increases) or through approaches that would impair Ohio's competitiveness through new sales taxes on services that can be easily purchased in another state without such a tax.

Income tax credits and deductions often are created to influence taxpayer behavior or to benefit one or more special interest groups. Many impact a limited-time event or limited number of people, and all reduce revenue that otherwise would have been generated by the personal income tax. A thorough review can determine if the credit or deduction can be eliminated or reduced, allowing more revenue to flow into the GRF and help pay for any income tax rate changes necessitated by bracket reductions. By reducing the number of brackets and the possible related changes in rate, many existing credits and/or deductions may not be necessary. It is important to examine whether the stated purpose of each credit and deduction has resulted in the intended goal.

Business Income Deduction (BID):

In Ohio, the tax on pass-through income has been largely mitigated by the new Business Income Deduction (BID) and for 2015 and thereafter the reduced 3% income tax rate that applies to pass-through entity business income above $250,000. The Ohio General Assembly and the Administration should consider these questions: Is the BID and the accompanying 3% income tax rate—expected to cost Ohio well over $500 million each year in foregone income tax revenue—spurring economic growth in Ohio? Alternatively, should the Legislature consider an overhaul of the entire personal income tax system for all taxpayers, not just for business owners?

While we strongly support the goal of helping small business owners in Ohio thrive, we also encourage a careful evaluation to determine if the desired economic growth is taking place with this important group of business owners. This recommendation to evaluate the results of the BID and the new 3% maximum income tax rate is consistent with OSCPA's past encouragement of our state leaders to carefully and periodically evaluate **all** tax expenditures to ensure they are meeting their intended goals.

Marriage Penalty:

However, there is one area where an additional tax expenditure should be considered: fixing Ohio's marriage tax penalty. In Ohio, a married couple filing a joint tax return pays a higher income tax than a married couple filing separately or two single individuals with the same amount of income. Consideration should be given to either allowing a different filing status for Ohio from the federal status or creating a new tax table for married filing joint returns and eliminating the current Joint Filing Credit.

When comparing Ohio's personal income tax policy to other key states, it's important to remember that factors beyond the rate itself also impact total revenue collected. For example, each state treats standard deductions and personal exemptions differently, meaning the amount of income subject to taxation varies. Further complicating comparisons is the reality that not all states use federal adjusted gross income ("AGI") as their starting point. Simply having a stated low tax rate does not necessarily mean taxpayers will pay less tax, as the optics of a low tax rate with almost no offsets to income are far different than a higher tax rate with many offsets. In summary, you need to look beyond the gross marginal tax rates to find the actual effective tax rate to make a valid comparison.

MUNICIPAL INCOME TAX

As lawmakers evaluate Ohio's personal income tax system, recognition must be given to our state's unique role of having over 600 cities and villages that also assess an income tax in addition to the state income tax – the average local add-on income tax rate for all municipalities is 1.89%.

Ohio municipalities are allowed to assess an income tax in two ways: 1) on individuals living and working within its boundaries (individual income tax), and 2) on businesses providing goods or services within its boundaries (net profits tax). Therefore, it is important to note that there are two separate forms of municipal income taxation: the payroll withholding tax and related filing requirements processed by businesses for individuals they employ (plus any payments due directly from individuals who are self-employed), and the net profits tax assessed on business entities.

Ohio is at a significant disadvantage regarding municipal income taxes since only 10 other states have a system whereby cities and villages can assess tax both where you work and live. OSCPA's primary concern is not the amount of tax charged by cities and villages to their residents, but rather the compliance cost associated with filing in multiple jurisdictions, particularly since some municipalities are getting much more aggressive with their collection efforts.

Recommendations:

There are three specific recommended changes that Ohio CPAs believe would significantly improve the time, cost and effort involved with multiple net profit return filings: 1) adopt some form of centralized collection and administration for business filers; 2) eliminate municipal "throwback" rules, which states that sales of goods shipped to a customer in another tax jurisdiction where the seller does not have an employee that regularly engages in the solicitation of sales (e.g., internet sales companies likely do not have any employees that solicit sales at a physical location other than over the internet) are "thrown back" to the jurisdiction from which the goods are shipped; and 3) prevent double taxation by requiring all cities and villages to give 100% reciprocity credit for taxes already paid to the municipality where the employee works, OR charge non-residents a lower income tax rate, recognizing that the individual does not live in the jurisdiction and therefore does not use city services to the degree that residents do.

COMMERCIAL ACTIVITY TAX (CAT)

OSCPA has a longstanding position that the CAT is effective as long as the following criteria remain intact: the rate is low, the base is broad, the exemptions are few and compliance is simple. The primary benefit of Ohio's approach is the uniform, low rate of 0.26%, which mitigates the concern about pyramiding. If Ohio bifurcates or increases its rate, the effect would become even more burdensome. The higher the rate, the more dramatic the problem is with the CAT's pyramiding structure. A major reason why the CAT rate has remained low is that the base is very broad, as intended from inception. Therefore, exemptions must be limited because tax expenditures affect CAT revenues. OSCPA supports the commitment when the tax was first passed in 2005 to a broad base, limited exclusions and a low rate.

Recommendations:

The CAT is a simple tax to administer, yet improvements can be made in the areas of administration, compliance and enforcement: 1) simplify the definition of gross receipts by tying it to the definition of federal gross income; 2) eliminate or revise CAT exemptions; 3) reduce or eliminate the CAT administration earmark; 4) address the "estimation" procedures as they are inadequate for large multistate companies; 5) address the Research & Development (R&D) credit within the CAT as it has created complexity with filers; 6) amend the combined (mandatory) and consolidated (elective) filing methods for commonly owned persons; 7) adopt provisions that put private equity firms on par with commonly owned corporate groups; 8) add additional funding for the Ohio Board of Tax Appeals (BTA); and 9) pursue out-of-state companies more aggressively.

SALES & USE TAX

Like most taxes, Ohio's sales and corresponding use tax can be divided into four main areas of discussion: (1) tax rate, (2) exemptions, (3) tax base and (4) compliance and enforcement.

In comparing the sales and use tax rate to other states, the 5.75% state sales and use tax rate ranks Ohio in the middle of the pack of all states (27th). However, when the average county and transit authority local sales tax rate of 1.39% is added, Ohio jumps to the 19th highest combined sales and use tax rate in the country and the highest among our neighboring states.

As for exemptions, it is important that they are competitive so that businesses and consumers will not turn to other states for those services or goods, and they should apply to a broad base that has a real impact on driving economic development in our state, such as the manufacturing exemption, rather than granting carve-outs for small niche industries.

During the past two biennial budget proposals, OSCPA has strongly opposed the expansion of the Ohio sales and use tax base to include professional services. OSCPA applauds the General Assembly for declining to expand the tax base to include these services. The challenges are many when expanding the sales tax to include professional services: 1) the competitive disadvantage small businesses would face compared to larger companies since they typically cannot afford to have full-time legal, accounting or other professional staff and must hire firms to provide those services; 2) Ohio should avoid driving business away from our state because of the reality that many services are highly mobile in nature, meaning they can be easily provided digitally or electronically from virtually anywhere in the world; 3) sourcing rules present a significant challenge; and 4) sales between affiliated companies should always be excluded, which otherwise could cost millions of dollars for a single taxpayer.

Adding sales or use tax to sales on professional services or between affiliated companies will significantly drive up the cost of goods made in our state, as well as services provided by professionals in Ohio. Either of these changes will make Ohio-based business operations less competitive when compared to almost all other states.

Compliance is an issue for both sales and use tax, but especially use tax. There are opportunities for Ohio to significantly improve compliance and enforcement among businesses through the Business Gateway, sales or use tax reporting, remote sellers, refunds, and payment plans.

Recommendations:

OSCPA's sales and use tax recommendations are as follows: 1) explore expanding the definition of sin tax to allow for economic development purposes; 2) review the sales tax on business fixtures under R.C. 5701.03; 3) reduce or cap vendor discounts; 4) eliminate the exemption for tangible personal property used in storing, preparing, and serving food; 5) clarify the law concerning automatic data processing (ADP) and electronic information services (EIS); 6) streamline sales or use tax on employment services; 7) upgrade the Ohio Business Gateway (OBG); 8) report and collect sales tax for small business remittance on a cash (not accrual) basis; 9) collect tax that is currently due under existing law from out-of-state (or remote) sellers; 10) permit taxpayers to enter into a payment plan with the ODT; 11) reduce interest payments; 12) combine sales/use tax filing to one form; and 13) enact legislation to ban zappers.

SEVERANCE TAX

OSCPA's recommendations in the severance tax section are focused primarily on issues impacting administration of the tax in various approaches. We do not have a position on the rate that should be charged. Please see pages 29-32 of the report for those recommendations.

OTHER STATE TAXES

While Ohio's personal income tax, CAT and sales tax generate the majority of revenue for government operations, there are a number of other taxes in our state that result in increased government revenue, as well as increased compliance and financial cost to Ohioans. For all forms of taxation, there should be consistent treatment within each category, meaning that exemptions should be avoided, particularly when it benefits one class of business over other direct competitors. Highlighted below are additional taxes levied by the state and recommendations to keep Ohio competitive while maintaining economic fairness and stability.

Recommendations:

We encourage the legislature to take steps to ensure Ohio's Unemployment Compensation Trust Fund is fiscally solvent long into the future. Few if any would argue that the existing funding formula can properly prepare our state for future high rates of unemployment and the related drain on resources that will surely result during another downturn. Ultimately, compromises by both the business community (in terms of what they pay into the Fund) and by employees (on what they are eligible to receive) are necessary to address the funding issue.

Second, we encourage the Ohio General Assembly to consider equalization of our state's cigarette tax to other nicotine products. OSCPA believes the key factors at hand are fairness and consistency of treatment. Therefore, when using fairness as a best practice measurement, Ohio should not assess the tax on tobacco-oriented products that do not contain nicotine.

Third, we urge the Ohio General Assembly to make an apples-to-apples comparison to other states when examining the promotional spend issue for possible changes. Since Ohio casinos began operating in 2012, over $383 million in tax-free promotional spend has been redeemed by casino customers. That figure climbs to $807 million when Ohio's seven racinos are added. Casinos and racinos deduct the amount of promotional play used in their facilities from gross revenue before tax is assessed per current law. Roughly one-third of this amount is foregone tax revenue that otherwise would have been received by Ohio's primary and secondary schools and local governments.

Further, we support the legislature continuing to cut red tape and expand efficiencies through consolidation. For example, one such area relates to payroll tax compliance audits with ODJFS and BWC. Because the ODT collects payroll taxes and has far more experience with the tax audit function, we suggest that ODJFS's unemployment tax division be transferred to ODT, and ODT work with BWC to find a more common sense approach to audit premium collections.

Finally, as previously discussed, credits and deductions need **independent** evaluation periodically as to their direct cost, utilization, and direct and indirect benefits to the Ohio economy. This information can then be used to determine the need to extend or renew them.

POTENTIAL SOURCES OF TAX REVENUE

While OSCPA is reluctant to call out any particular class of taxpayer, there are several areas where a closer look could be taken to determine if there should be more fairness in tax treatment and application. Some are areas where technology advances have opened the door for efficiencies; others where some industries have generous exemptions that may no longer make sense.

A few have already been mentioned, including promotional spend for Ohio's casinos and racinos, the sales tax vendor discount, and equalization of the cigarette tax to other nicotine products. In addition, with 52% of Ohio's budget dedicated to Medicaid expenditures, lawmakers should closely evaluate whether benefitting Ohio facilities are paying their fair share through health care provider taxes for the privilege of doing business in our state. Also, Ohio could join the many other states that place heavier emphasis on permanent user fee increases in place of taxes imposed on all, which burden those who do not even benefit from a given program, facility or service. Finally, the new Business Income Deduction (BID) merits additional study to ensure it is achieving its stated goal: largely, reinvestment of these tax savings by business owners into their operation(s). Changes could bring substantial revenue.

SUMMARY

Striving to make the state of Ohio a magnet for employers to locate and grow their businesses, and for skilled workers to live and raise their families, is critical to ensuring economic competitiveness. Reducing the tax burden on businesses and individuals alike is an important part of that equation, but is far from the only factor to be considered. Ohio's workforce is also of critical importance, both ensuring that our future workers are prepared to enter the job market and our state is attracting and retaining skilled workers for our key industries. A major concern expressed by employers is the lack of a ready workforce to fill the jobs that are available now.

Any efforts to update Ohio's tax system need to focus on the major tenets of good tax policy: competitiveness, simplicity, stability, equity/fairness and neutrality, and the recognition that there are two key cost components associated with tax policy: the tax rates themselves and the compliance costs impacting both taxpayers and government entities receiving tax dollars.

While every state is different, it is helpful to learn from successes and failures in other states. Significant research should first be done—particularly in view of recent major income tax reforms—to ensure that any further significant proposed tax changes likely will result in meaningful job and economic growth without hurting the state financially. Significant research should also be done on the dozens of Ohio tax credits, deductions and exemptions, including Ohio's new Business Income Deduction. One of the best ways to reduce a rate and simplify compliance at the same time is to eliminate tax expenditures that are not critical to our state's economy.

Where the major taxes are concerned, OSCPA believes that moving to a reduction in the number of personal income tax brackets, coupled with relatively few credits and deductions, should be considered by policy makers to make Ohio's tax system appear more competitive with surrounding states. Optimally, Ohio would have no more than three brackets, as the fewer the better for simplicity. OSCPA also believes that moving to a flat rate likely is too financially challenging over the long term—depending on the rate, of course. Sustainable funding of key government services is crucial.

Moving to fewer brackets and/or lower rates likely will result in a loss of revenue to the state, giving rise to the related challenge of how to offset those losses. The fairest and most appropriate way to fund this shortfall, beyond cuts in government spending, is through the elimination of related personal income tax credits and deductions. Creating new revenue from a completely different source of taxation, such as the CAT or the sales tax, does not achieve the goal of reducing the Ohio tax burden—it simply reallocates it by increasing another tax, thereby picking winners and losers. We strongly discourage such an approach as it violates the fairness tenet of good tax policy.

Recognizing that reducing the cost of compliance is also important, we have recommended a number of possible changes to each of the major Ohio taxes. The Ohio Society of CPAs stands ready to work with members of the Ohio General Assembly and the Kasich Administration on the important, ongoing effort to make Ohio a destination state for employers, as well as the skilled workers they need to thrive.

Thank you again for this opportunity to offer testimony on Ohio's tax policies, and for your consideration of OSCPA's recommendations. I'm available to answer any of your questions.

Testimony to the 2020 Tax Policy Commission

By Zach Schiller and Wendy Patton

Chairmen Peterson and Schaffer and members of the committee: My name is Zach Schiller and I am research director at Policy Matters Ohio, a nonprofit, nonpartisan organization with the mission of creating a more prosperous, equitable, sustainable and inclusive Ohio. Thank you for the opportunity to testify today.

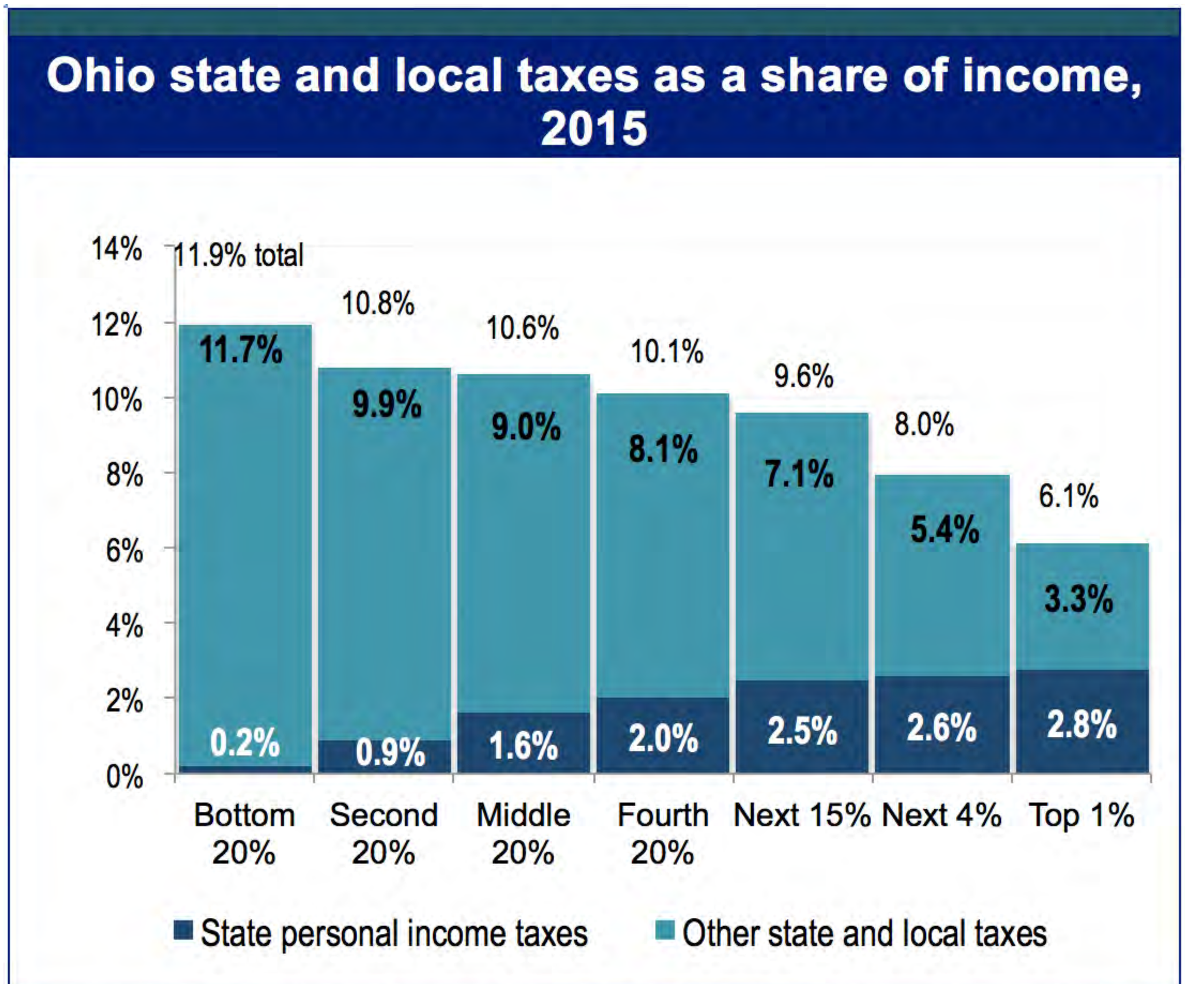
Ohio needs a tax system that will generate adequate revenue to make the investments we need for our state to thrive. Ohio has important needs that are not being met, while critical indices of community well-being lag: A recent public health assessment noted that several national scorecards place Ohio in the bottom quartile of states for health, and the state's performance on population health outcomes has steadily declined relative to other states over the past few decades. College education is even more unaffordable, and student debt higher, than the unenviable national averages. Pre-K enrollment of low-income children lags far behind the national average, and Ohio is also among the hardest of states in which to get childcare aid. Public transit service is being cut in Cleveland, and fares raised, even as hundreds of millions of dollars are needed statewide to replace existing equipment and meet future needs, according to a state transportation department study.

Yet state policy has been directed at reducing taxes, despite these needs. Since 2005, the General Assembly has cut the state income tax rates by a third, created a huge new income-tax exemption for business income, eliminated our corporate profits tax, repealed a major local business property tax on machinery, equipment and inventory and jettisoned the estate tax. To pay for part of this, it has increased the sales tax, boosted the cigarette tax, and created a new business tax on gross receipts, the Commercial Activity Tax. The advent of casinos and racinos also has led to taxes on those activities. But the net is a reduction in revenue of more than $3 billion a year.

Advocates of these tax cuts have argued that they are needed to boost the economy. But if that was the theory, it has not worked out that way. We have more than a decade of experience, and can look at how Ohio has done. If the tax cuts were as crucial as they were supposed to be, one would think by now we should have seen positive results. But our job and household income growth have lagged behind the nation. More on this later.

Who has benefited from the tax cuts? Primarily, they have gone to affluent Ohioans. Overall, the top 1 percent, who made more than $360,000 a year in 2014, received an average annual tax cut of $20,000 from the major tax changes between 2005 and 2014 (that doesn't include last year's cuts). On average, Ohioans in the bottom 60 percent of the income spectrum (making $54,000 or less) are paying slightly more. These numbers came from an analysis by the Institute on Taxation and Economic Policy, a national research group with a sophisticated model of state and local tax systems. This added to the tilt of Ohio's state and local tax system in favor of the wealthy, shown in Table 1 below:

Table 1.



Source: Institute on Taxation and Economic Policy, April 2016. Based on 2012 income levels and includes nonelderly Ohio residents. Shows permanent, fully-phased in law in Ohio enacted through April 1, 2016 at 2012 income levels. Changes from the published 2015 version of Who Pays? include these changes adopted in last year's biennial state budget: personal income tax rate decreases, preferential treatment of business income, means-testing of retirement credits, and a cigarette tax increase. Changes made to Ohio's municipal income tax system in December 2014 are not reflected.

As Table 1 illustrates, the bottom fifth of Ohioans is paying almost twice as much of their income in state and local taxes as those in the top 1 percent do. Middle-income Ohioans also pay more of their income in state and local taxes, 10.6 percent, than the top 1 percent (the income groups in Table 1 are slightly different than those cited previously on the impact of the 2005-2014 tax changes because it is based on incomes from 2012). Much of the tax shift results from the reduction of the income tax and its partial replacement with sales- and cigarette-tax revenues. These fall more heavily on lower- and middle-income residents. *Ohio's tax system is adding to inequality*.

A study earlier this year found that most of the richest people in the country choose where to live based on something other than tax rates. This research severely undercuts claims that the income tax causes the richest residents to flee to states with lower tax rates. Researchers at Stanford University and the U.S. Treasury Department examined all tax returns for million-dollar income-earners across the country over 13 years – 45 million tax records in all – and found that such tax flight occurs, "but only at the margins of statistical and socioeconomic significance." The authors concluded that, "The most striking finding of this research is how little elites seem willing to move to exploit tax advantages across state lines in the United States." I strongly urge that you read this study, which debunks a key rationale for the income-tax cuts Ohio has approved.

Nor are many of the most highly valued private companies flocking to low income-tax states. Policy Matters Ohio recently looked at where some of the highest-profile start-up companies are located, to see if state income taxes played a role. Such companies as Uber, Airbnb, Snapchat and Pinterest, dubbed "unicorns" by Wall Street, have been valued by their investors at $1 billion or more.

We found that by far the largest number of these companies – a whopping 55 of the 87 U.S.-based firms on a list compiled by the Wall Street Journal in April – are located in California. That state has by far the highest top income-tax rate in the country, at 13.3 percent. Another 10 are in New York State, whose top rate of 8.82 percent ranks 6th highest in the nation. A paltry five unicorns are based in states without income taxes (Florida, Washington and Texas).

Clearly, income taxes aren't an impediment to these high flyers. Some of these firms will never meet their investors' high expectations and will instead fizzle out. The valuations mark just one point in time; already, some of them have run into trouble. And of course, a lot more goes into regional economic success than where these high-profile businesses happen to establish themselves.

However, like the recent study on millionaires, their locations are one more sign that arguments for lower income taxes may sound simple and convincing, but have little basis in fact. For a variety of reasons, cutting taxes is no prescription for economic vitality. While this might surprise some, it's really not that surprising. Companies can only thrive where there are well-trained workers, good transportation, and strong markets. Those require public investment in schools, infrastructure, worker training and services.

Overall, Ohio's taxes are not high. Data from the U.S. Census Bureau reported on the state taxation department web site for Fiscal Year 2013 (see http://www.tax.ohio.gov/Portals/0/tax_analysis/tax_data_series/state_and_local_tax_comparison/tc12/TC12CY13.pdf), the most recent available, show that per person, our state and local taxes amount to $4,275, slightly less than the national average of $4,604. As a share of personal income, Ohio state and local taxes are 10.6 percent of personal income, virtually the same as the 10.5 percent nationally.

Policy Matters Ohio testified previously on tax expenditures, so I will not go over that in detail here (see our earlier testimony: http://www.policymattersohio.org/taxbreak-testimony-march2016). Since then, the Senate has passed its own version of House Bill 9, the bill sponsored by Rep. Terry Boose that would set up a permanent committee to review tax expenditures. We hope that this commission will help ensure that House Bill 9 is approved this year, in line with your mission to review the state's tax structure and tax credits in particular. In addition, the committee should recommend that in next year's biennial budget, funding be included for the Legislative Service Commission to do a thorough study of each tax expenditure prior to its examination by the review committee.

We should learn from the Kansas experience. It has experienced poor economic growth and persistent budget problems since its legislature slashed income taxes, something Gov. Sam Brownback said at the time would be "like a shot of adrenaline into the heart of the Kansas economy." In July, Standard & Poor's downgraded Kansas's credit rating for the second time in two years, from AA from AA-, leaving Kansas below 41 other states.

Moving to a flat-rate income tax would be ill advised. As you have seen, Ohio already slants its tax system against low- and middle-income residents, and a flat-rate tax is likely to further increase that. Under a 3.5 percent or 3.75 percent flat tax, most Ohioans would pay more so that a tiny share could pay less. Our graduated tax system means that a flat tax is likely to have that effect. This explains why Tax Commissioner Testa earlier told you that, "It's going to be hard to come up with a rate that doesn't create a lot of losers."

Even aside from the higher taxes that a flat rate is likely to mean for most Ohioans, there are other reasons why such a move is not sensible.

- It won't do anything for small business – you already have cut the income tax to zero for the first $250,000 in business income, and set a 3 percent rate on income above that amount.
- It has no direct connection to state economic performance. Among the seven states that have had a flat-rate tax for the past decade, three have shown better job growth than the nation as a whole. But four have lagged behind – and those four happen to be the ones most similar to Ohio: Illinois, Indiana, Michigan and Pennsylvania.
- It won't simplify the tax system; the number of brackets does not matter when most taxpayers can simply find their rate in a table, whichever bracket they happen to be in. Simplifying the system can be done by cutting unnecessary tax expenditures, but that has nothing to do with a flat tax.
- It could hurt the state's ability to finance services going forward. Over time, the income tax more closely tracks the growth in the economy than the sales tax, which covers a smaller share of purchases with each passing year. Ohio should rely on a diverse set of revenue sources to provide adequate funds for needed services and growth in revenue over time.

In short, a flat-rate tax should be a non-starter.

In fact, the income tax should be stronger, not weaker. Besides making the tax system fairer, that would add to the state's financial resources. It would allow for needed capital investments and make it easier for the state to stay within the 5 percent debt limit. Ohioans also are assured by a constitutional provision that at least half of the income tax that is collected from within their school district or local government will return there

Ohio needs to modernize its tax system so that it covers today's – and tomorrow's – economy, not yesterday's.

As the service sector grows and online purchases proliferate across a growing swath of the economy, the tax system needs to cover those sectors. Otherwise, they receive an implicit subsidy – be it software that is sold online compared to in a store or an Airbnb booking compared to a hotel room. While we have taken some steps in that direction, such as the provision in the 2013 budget bill extending the sales tax to digital goods and services such as Netflix, I-Tunes and e-books, we have not done nearly enough to adapt our tax system.

Ohio should ensure that our tax system is appropriately updated to respond to what some have called the gig economy. Our sales tax already is supposed to cover Uber, Lyft and other transportation network companies, though it remains unclear to the public if these entities are all collecting it. Airbnb has voluntarily agreed to collect local lodging tax in Cuyahoga County, and Cleveland approved an ordinance under which the company is collecting the city's 3 percent bed tax. But state law needs to be revised so that state sales tax is required on these bookings when the establishment has less than five rooms. In addition, the online booking agent should be responsible for remitting the tax, and the tax should cover its fees along with the cost of the rooms themselves. Localities should be permitted to levy their own taxes on these entities, just as they are with hotels.

As you know, the federal government has told Ohio that we need to adjust our sales tax on managed care organizations to meet U.S. requirements. Besides the need to address the state's own finances, the tax also provides close to $200 million a year to counties and transit agencies. The state needs to find a fix that protects health care but also local public finances.

Modernizing our tax system also means overhauling the severance tax so that it captures more than the current tiny share of revenue from hydraulic fracturing. Studies of the oil and gas industry over the past 40 years make clear that state tax rates have miniscule impact on oil and gas production. The state of Ohio needs to join other major producing states with a severance tax that covers the external costs of production imposed on roads, bridges, public health, housing and other civic functions of local government, and builds a stronger economy for when the natural resources are depleted. We recommend a 5 percent severance tax on the value of oil and gas, with an additional 2.5 percent during periods of high production and high prices, to be put aside in a permanent fund for economic development, education and other long-term investments.

Bringing our tax system up to date also means collecting the use tax due on catalog and Internet purchases. This is not a new tax; the use tax has been in place since the 1930s. Enforcing existing law is not a tax increase. As you probably know, a number of states have passed legislation attempting to see that more of this tax is collected, or challenging the U.S. Supreme Court's 1992

Quill decision that prohibits states from imposing sales and use collection obligations on businesses without an in-state physical presence.

Ohio may want to consider enacting a law like that in Colorado that requires companies to notify customers that they may owe use tax and report annually to state tax authorities on purchases made by individual customers. It also calls for providing an annual report to each customer compiling their total purchase information, along with a statement that the total purchase information (but not the item breakdown) has been provided to their state's revenue department and that they may owe use tax on their purchases. This law, a form of which also was recently enacted by Louisiana, has been upheld by the 10th Circuit Court of Appeals. Regulations in Colorado exempt businesses with less than $100,000 in annual sales in the state, and the annual report to customers is only required if the buyer bought more than $500 in the preceding year. The law also provides that no information about the nature of the purchases is to be provided to the revenue department, just the dollar amount. Such a law would not be a complete answer, but would make a good interim step while we wait for action by Congress and the U.S. Supreme Court.

Separate from the collection of taxes already due, the shrinking share of Ohio's economy that is covered by the sales tax mandates a long-term evaluation of adding services to the sales-tax base Some services clearly should be added. These include lobbying and debt collection, both of which Gov. Taft unsuccessfully attempted in 2003. In particular, we should evaluate consumer services and add to those that are covered by the tax.

We should not move in the opposite direction and remove the sales tax from temporary employment services. This would encourage companies to hire temporary workers instead of creating regular employment with stability. It would work against legislative efforts to reduce reliance on public assistance, as a number of temporary staffing firms rank among those with the most employees receiving nutrition aid. It would weaken the state's tax base and reduce revenues for local governments and transit agencies.

While Ohio needs to broaden its sales tax to capture a greater share of purchases, that will affect low- and moderate-income residents more than others, as they would pay the most as a share of income. In order to offset this, the General Assembly should consider the adoption of a sales tax credit, in use in a number of other states. These credits provide a set amount for each family member to offset some of the cost of a sales or similar tax. See our 2013 report: http://www.policymattersohio.org/wp-content/uploads/2013/04/SalesTaxCreditES_Apr2013.pdf

At the same time, we need to expand our state Earned Income Tax Credit. The General Assembly took positive steps over the past three years in creating a state EITC and raising it to 10 percent of the federal credit. The federal EITC alone helped 177,000 working Ohioans, including 93,000 children, stay out of poverty each year from 2011-2013, and it eased poverty for many more. However, the state EITC could be a much more powerful tool for helping working families make ends meet and provide for their children. Because of limits imposed on its value, just a tiny share of the poorest workers see any benefit from the credit and the benefit is modest. Unlike the federal credit, Ohio's EITC cannot exceed what a taxpayer owes in income taxes, and for a taxpayer with income over $20,000, it cannot exceed more than half of what he or she owes in income taxes. That means that it does nothing to reduce the substantial share of income these same taxpayers pay in sales taxes and property taxes. If the General Assembly removed these limitations, the state EITC would reach far more of the workers who need it most and be a better-targeted income support.

Over the generation between the late 1970s and the first decade of the new century, the share of Ohio state and local taxes paid by business declined while that of individuals increased. Then, in 2005, the General Assembly approved the phase-out of two major business taxes – the corporate franchise tax on nonfinancial companies and the tangible personal property tax – and their replacement with the new Commercial Activity Tax. One clear result was a significant reduction in business taxes. Even in the bad recession year of 2009, the old corporate franchise tax would have generated nearly $1.4 billion, and nationally, state corporate income taxes have increased since then. The tangible personal property tax regularly generated at least $1.6 billion. Based on CAT revenue in fiscal year 2014, the net loss in annual revenue is in the neighborhood of $1.5 billion. As the Ohio Business Roundtable told the Ohio Supreme Court in a 2008 filing: "The new business tax system substantially lowered the overall tax burden on business." These cuts are still reverberating through local governments, and reducing the amounts that levies across the state bring in for everything from children's services to community colleges.

More recently, owners of S Corporations, limited liability companies, partnerships and other business entities who are taxed on their profits through the personal income tax received a break on that tax. Altogether, this is likely to become the second-largest tax expenditure of any the state tracks, amounting to as much as $800 million a year. Business owners in general hire or expand when there is a growing market for their products or services, not because they have more cash in their wallets from lowered taxes. There was little reason to think this big new tax break would accomplish much in the way of boosting the economy – and indeed, the overall results have been weak. Since it was approved in 2013, the tax break has not produced overall job gains for the state or a significant increase in employment at small businesses that were hiring for the first time. According to the U.S. Bureau of Labor Statistics, such small Ohio businesses in 2015 were hiring fewer new employees than comparable small companies were a decade earlier, when major cuts in income-tax cuts were enacted.

To be clear: No one is suggesting that we should reinstate the tangible personal property tax. However, Ohio is one of only six states without a corporate income tax. We should restore a solid corporate income tax, so that companies pay taxes on their profits, and integrate it with the CAT, so that we make up some of the revenue lost with the 2005 business tax changes.

We have more than a decade of experience with income and business tax cuts. Ohio job growth has underperformed the national average since the big 2005 tax cuts were approved (1.6% vs. 7.9%), since January 2011 (8.6% vs. 10.5%), and over the past 12 months (1.4% to 1.7%). At the same time, previous increases in the income tax did not lead to job losses. The 7.5 percent top income-tax rate adopted under Gov. George Voinovich in 1992 did not prevent Ohio from generating more than 100,000 jobs each year from 1993 to 1995. We have not managed that any time in recent years, while cutting top income-tax rates. The evidence is clear: Tax cuts are not the answer.

Thank you for the opportunity to testify. I would be happy to answer any of your questions.

Policy Matters Ohio is a nonprofit, non-partisan research institute with offices in Cleveland and Columbus.

COST
COUNCIL ON STATE TAXATION

Testimony to the Ohio 2020 Tax Policy Study Commission

Fred Nicely
Senior Tax Counsel
September 26, 2016

Co-Chairs Senator Peterson and Representative Schaffer and Members of the Commission, I appreciate the opportunity to testify today on ways Ohio can improve its business climate. I will highlight several tax areas where the Council On State Taxation recommends improvements to foster a better business environment in Ohio.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. Many COST members do business in Ohio and are impacted by changes to Ohio's tax structure.

Municipal Income Tax Reform Opportunities

Ohio's municipal income tax system retains its complexity, with a plethora of separate taxing districts, despite the Legislature's efforts to provide greater uniformity and filing simplicity with 2014's House Bill 5. The COST Board of Directors has adopted a formal policy position with regard to tax administration. That position is:

> *Fair, efficient and customer-focused tax administration is critical to the effectiveness of our voluntary system of tax compliance. A burdensome, unfair, or otherwise biased administrative system negatively impacts tax compliance and hinders economic competitiveness.*

The State's municipal income tax system presents many issues for business taxpayers that the Legislature could address to improve the State's attractiveness to business. The ideal solution would be for the Legislature to find a way to eliminate the net profits portions of the municipal income tax. Barring that step, this Commission should consider enhancing the uniformity of the municipal income tax by requiring it to be centrally administered. Listed below are some other improvements COST believes this Commission should make to strengthen the reforms passed in 2014.

Net Operating Loss Provision. It is axiomatic that income-based taxes should account for the cyclical nature of business by allowing businesses to offset income in future years by losses from prior years. COST strongly believes the municipalities should follow the Internal Revenue Code's net operating loss rules, which provides a 20-year carryforward period (federal law also allows a taxpayer to carry back losses). To stress the importance of providing taxpayers with NOLs, the financial impact of a company with a large NOL was addressed by the Ohio General Assembly when it adopted the Commercial Activity Tax — see R.C. 5751.53.

"Throwback" Rule. Ohio's municipal income tax system should not embrace the "throwback" rule, which assigns sales to a municipality even though the sale would otherwise be properly sourced to another jurisdiction. As provided in COST's policy statement on the subject, throwback rules "seek to require companies to pay tax in one [tax jurisdiction] on income that another [tax jurisdiction] has chosen not to tax or is legally unable to tax. A company's tax liability in one [tax jurisdiction] should not be measured by its tax in another [tax jurisdiction]. Throwback (and throwout) rules also discourage investment in a [tax jurisdiction]." In sum, throwback rules tax "income at the wrong rate and direct the resulting revenue to the wrong [tax jurisdiction]." A municipality should only tax the activity occurring in its jurisdiction; how other taxing jurisdictions throughout the state (and world) tax a business is not relevant for apportioning the income of a business to a municipality in Ohio.

Uniform and Equalized Interest Rates with State Taxes. Ohio's municipal income tax system should require the municipalities to use the same interest rate that is used for most of the taxes administered by Ohio's Tax Commissioner. As it stands now, Ohio's municipal income tax system requires municipalities to impose an interest rate that is two percent greater than the state rate.

Nonresident Workers. H.B. 5 helped to clarify when Ohio's municipalities can impose their tax on nonresident workers, alleviating some of the administrative burdens facing employees, employers and tax agencies with *de minimis* tax return filing requirements. However, the bill only uses a 21-day threshold. COST is very supportive of proposed federal legislation, H.R. 2315 (the Mobile Workforce State Income Tax Simplification Act) and S. 386, which provides a 30-day threshold before a state can impose its income tax on certain workers, with exceptions for professional athletes and entertainers. This same 30-day threshold should be incorporated in Ohio's municipal income tax system.

Taxes Paid Credit. This Commission can also improve the State's municipal income tax system by requiring municipalities to provide taxpayers and their employees with a credit for taxes paid to other municipalities. Subjecting employees to municipal income tax based on both where they work *and*, where they live, without requiring a one-hundred percent credit for taxes paid at one of those locations makes Ohio a less attractive state to draw new employees. This Commission should recommend ending this bad tax policy.

Sales Tax Reform

In a perfect world, sales taxes imposed by states would fall entirely on consumers. The COST Board of Directors has adopted a formal policy statement on sales taxation of business inputs. COST's policy position on the imposition of sales tax on business input is:

> *Imposing sales taxes on business inputs violates several tax policy principles and causes significant economic distortions. Taxing business inputs raises production costs and places businesses within a State at a competitive disadvantage to businesses not burdened by such taxes. Taxes on business inputs, including taxes on services purchased by businesses, must be avoided.*

Unfortunately, Ohio's sales/use taxes are imposed on numerous business-to-business transactions. Currently, approximately 42% of Ohio's sales/use tax revenue is derived from business-to-business transactions, increasing to 52% if the CAT is included.[1] The State's imposition of such a heavy tax burden on business-to-business transactions does not foster a positive environment for businesses to locate or remain in Ohio.

Ohio targets its sales/use tax on automatic data processing, computer services, and electronic information services exclusively on the business sector. Other services, such as janitorial services and employment services, also predominantly fall on the business sector. Further increases in the State's sales/use tax rate, without eliminating the tax on business inputs, will not make Ohio more attractive as a business location. In fact, such taxes would likely be borne disproportionately by small businesses, since larger businesses would be incentivized to provide these services in-house to avoid the tax, a strategy small businesses typically cannot afford.

Ohio can take a step toward ameliorating these issues by coming into compliance with the Permanent Internet Tax Freedom Act, federal legislation (H.R. 644) passed in February 2016 that prohibits states and localities from levying taxes on internet access. While the federal law permits states until June 2020 to phase-out their existing taxes on internet access, Ohio should immediately comply with the Act to reduce the State's business tax burden. COST also encourages this Commission to recommend passage of Ohio House Bill 343, which would repeal the application of sales tax to employment services.

CAT Rate Increases Exacerbates Problems with Gross Receipts Taxes

This Commission should seek ways to improve Ohio's Commercial Activity Tax (CAT) by keeping the base broad and rates low, though it should also seek ways to mitigate the detrimental rate pyramiding effects inherent with gross receipts taxes like the CAT.

The COST Board of Directors has adopted a formal policy statement on gross receipts

[1] Robert Cline, Andrew Phillips, and Tom Neubig, "What's Wrong with Taxing Business Services," Ernst & Young in conjunction with COST, April, 2013; Daniel Mullins, Andrew Phillips, and Daniel Sufranski, "Analysis of Proposed Changes to Select Ohio Taxes Included in The Ohio Executive Budget and Ohio House Bill Number 64," Ernst & Young in conjunction with the State Tax Research Institute, March 2015.

taxes. COST's policy position is:

> *Gross receipts taxes are widely acknowledged to violate the tax policy principles of transparency, fairness, economic neutrality and competitiveness; generally, such taxes should not be imposed on business.*

Despite the well-known policy shortcomings of gross receipts taxes,[2] two mitigating factors noted during adoption of Ohio's CAT were its combination of a "broad base and low rate" and the elimination of the personal property tax (a tax that is also not based on profit) on general businesses. Ultimately, these factors drove the State's 2005 tax reform package that phased in the CAT and phased out the State's corporate income tax and personal property tax.[3] COST and others have remained concerned that increasing the CAT rate, even by a small amount, would in turn exponentially increase its pernicious effects as a gross receipts tax. The base of a gross receipts tax is so broad (many times greater than the State's gross domestic product) that even small rate increases will negatively impact businesses selling their products to customers in the State and conducting their operations within Ohio. The burden of the CAT varies based on:

1) An entity's gross receipts (*e.g.,* those under $150,000 pay no CAT);
2) Profit margin (*i.e.,* higher margin businesses do better than low margin businesses because of their profit differentials); and
3) The length of the supply chain it takes to get a good to an Ohio consumer (the longer the supply chain, the greater chance of "pyramiding").

Any increase in the CAT rate, even if limited to select industries, undermines the original intent of the CAT being a simple tax with a "broad base and low rate." As addressed in more detail below, increases in the CAT to select industries complicates the CAT, increases pyramiding of the CAT, and exacerbates the burden of the tax being imposed regardless of profitability.

Complexity: As the saying goes, the "devil is in the details," and any CAT rate differentiation between industries would require very precise language. Different rates, similar to the pyramiding concern addressed below, also create winners and losers. Differing rates also increase the difficulty of calculating the tax. Businesses will legitimately seek to use more tax planning to minimize the tax they would have to pay at the higher rate, inevitably leading to increased litigation. Texas and Washington are two states with a state-based gross receipts tax that have different rates, and tax administrators from both of those states have said it increases controversy, a direct result from businesses seeking to utilize a lower tax rate.[4] Other problems with using different tax rates for the CAT include, but are not limited to, the following:

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[2] John Mikesell, "Gross Receipts Taxes in State Government Finances: A Review of Their History and Performance," Indiana University School of Public and Environmental Affairs, January, 2007.
[3] Personal property tax was not eliminated for all businesses; certain public utilities are still subject to a personal property tax.
[4] *In re Nestle USA, Inc.,* 387 S.W.3d 610 (2012) is an example of litigation over the tax rate in Texas; and *Bowie v. Washington Dep't of Rev.*, 248 P.3d 504 (2011) is an example of a tax rate dispute in Washington.

1) Converting the CAT into a transactional tax could create problems with the CAT applying to food for off-premise consumption;[5]
2) More business-to-business transactions would likely be taxed at a higher rate;
3) Ohio businesses would be encouraged to minimize CAT exposure by transacting business with out-of-state companies that are not subject to the CAT;
4) Ohio businesses would be encouraged to locate operations outside of Ohio to minimize the CAT; and
5) Small Ohio businesses are hurt as they no longer get work from companies that have elected to insource some operations (or outsource outside the State) to avoid the CAT.

Pyramiding: Businesses that are both horizontally and vertically integrated can buffer the effects of the pyramiding of the CAT better than non-integrated businesses. Thus, businesses that cannot exclude related-entity receipts (*i.e.,* not part of a consolidated elective taxpayer group) are hit much harder than those businesses in control of the distribution chain (manufacturer to wholesaler to retailer, and on to the ultimate consumer). The effects of pyramiding within the CAT can be seen in the resulting 0.65% tax rate of Ohio's Petroleum Activity Tax (PAT), a tax rate to be revenue neutral when applied to only one distribution point as compared to the CAT which is applied to multiple points within the distribution chain, clearly proves the effect of pyramiding. That rate is 2.5 times the CAT rate. While the level of pyramiding varies industry by industry, increasing the CAT rate compounds the problems with the pyramiding effect of the CAT.

Imposes Tax Regardless of Profitability: The CAT is imposed on gross receipts regardless of whether a business is profitable. Businesses operating at a loss or at minimal profitability, such as a capital-intensive business at start-up, will incur a much higher tax burden with the CAT increase (*i.e.,* higher effective tax rate on profit) than those businesses with higher profit margins.

Real Property Tax Appeals

This Commission should recommend ending third-party appeals of real property valuations. The County Auditor is the entity vested with determining the fair market value of real property. Allowing school districts and other governmental entities to independently dispute property owners valuations, primarily targeted towards business properties, is unfair. The vast majority of the states do not allow this practice and it should be eliminated in Ohio. To that end, COST supports the passage of Senate Bill 85, which would prohibit school districts or other third-parties from filing Board of Revision complaints if the taxpayer has not filed a complaint on the property.

Conclusion

COST appreciates the opportunity to testify today. COST shares the same goal as the Ohio General Assembly – to grow Ohio's economy and create jobs in Ohio. I would be pleased to answer any questions.

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[5] *See* Ohio Constitution Article 12, § 3(C) and *Ohio Grocers Assn. v. Levin,* 123 Ohio St.3d 303 (2009).

OML
OHIO MUNICIPAL LEAGUE
Partnering for Stronger Cities and Villages

Kent Scarrett
Executive Director
Ohio Municipal League

2020 Tax Policy Study Commission

September 26, 2016

Good afternoon Chairman Peterson, Chairman Schaffer and members of the 2020 Tax Policy Study Commission.

My name is Kent Scarrett and I am the Executive Director of the Ohio Municipal League. I come before you today to share with you deep concerns from our membership. These concerns resulted from the testimony presented by advocates for tax preparing and business interests as they shared with you at this commission’s last hearing a "wish list" of changes. They encouraged the Ohio legislature to enact these changes, further altering municipal income tax ordinances and depriving Ohio cities and villages of the ability to generate revenue locally and to support the continuation of basic municipal services that businesses and residents demand and deserve every day.

In the testimony presented by the architects of HB5, the municipal income tax reform bill passed in November of 2014 and became effective January 1st of this year, you were presented with their version of the blueprint for "Phase II" of the ongoing threats to financial stability for Ohio's municipalities. As their next step in "reforming" how the municipal income tax is administered, they seek this body's approval to institute a centralization collection scheme. Were this to happen, the over 600 municipalities that have instituted a municipal income tax would lose the ability to collect or have direct access to their "life blood" revenue generated through the only mechanism available to Ohio cities and villages.

Even though the proponents of HB5 received almost every item they requested in the last local taxation "reform" bill, it has not satisfied their desire to continue to drive Ohio's municipalities further into financial insecurity. State centralized collection of municipal tax revenues will deny municipalities the ability to properly audit and enforce the business and resident filings that are owed those communities where employees work, raise their families and enjoy the services of their hometowns.

Our members unanimously oppose the concept of creating such a centralized collection and redistribution system for the revenue they depend on every day. As one legislator wisely remarked when talking about the idea, "It didn't work in the Soviet Union so why do they think it would work here?!" It is important to note that roughly 70% of Ohioans who live in a municipality that imposes an income tax happen to live in a self-collecting municipality.

Some members may not be aware that there is currently a centralized collection system right now for business filers to centrally file and pay their Net Profits municipal income tax returns and all employee withholding tax payment filings though the Ohio Business Gateway portal created by Governor Taft and the Third Frontier initiative. The Business Gateway portal is challenged by a lack of investment by the state and needs weaknesses in its functionality addressed; however, if proponents of centralized collection were honest about their motivation to ease the cost of compliance for business filers, as they have testified, it makes better sense to fix this year's-long investment by the Ohio General Assembly and not scrap access to greater efficiencies in tax filing for the business community.

During the June 20th commission hearing, you also were presented with the policy advice that the state should mandate that municipalities where a wage earner lives must grant 100% credit for any municipal taxes paid to another municipality where that resident may work. In effect, if the state were to initiate such a draconian municipal tax policy, millions of Ohioans would have no obligation to financially support the services they and their families benefit from in their home-base municipality. When Ohio's workforce comes home, they enjoy such basic services as a trained police force, dependable fire and rescue services, safe roads, clean water, controlled zoning practices and other services that make a civilized community a safe place to live and prosper. The revenue consequences, were the legislature to heed their advice, would be untold. But understand, it would not take long for Ohio's workforce to flee the Buckeye state, making economic development success a thing of the past.

Lastly, the third pillar of the business and tax preparation advocate's plan, targeting the very core of support for local services through the only reliable source of revenue generation for municipalities, is to eliminate the uniformly applied "throwback" rule. The elimination of the "throwback" rule was a part of HB5 in its early drafts but was removed by thoughtful members of the legislature due to the tremendous financial impact that would result. The "throwback" provision applies to sales generated though warehouse and distribution centers when a sale is initiated at point "A" and then shipped to location "B". The impact to communities across the state with businesses operating in these types of models is so significant that one city roughly ten miles from Columbus would lose 25% of their general revenue were the "throwback" eliminated. The city of Athens has previously calculated after reviewing only the top 5 employers in their community, if the "throwback" rule were eliminated, their revenue loss would be over $76,000 annually.

Were I afforded the time today, I could go into detail about the negative effects that past changes in state taxation and revenue sharing policies have already had on cities and villages of every size and in every region of Ohio. I know that each legislator here has heard repeatedly from their district municipal officials and other local government partners of the sacrifices that have resulted from the following: the 2011 passage of HB 153, cutting the Local Government Fund by 56% and resulting in an approximate $535 million loss; the elimination of Ohio's Estate tax resulting in approximately $200 million in losses to cities and villages; the accelerated phase out of the Ohio Tangible Personal Property tax; and the reoccurring decreases in the distribution amounts to the remaining LGF by repeated cuts in the state income tax. These have all meant less revenue and fewer LGF dollars flowing back to Ohio communities. These changes have created unnecessary pressures on Ohio municipalities to financially plan for future investment, sustainability of safety service operations, infrastructure demands and capital improvement projects - all benefiting the state as a whole for continued economic recovery. The changes made to our cities and villages financial stability would never be brought upon any other employer sector in the state. But somehow, some of the most powerful special interests in the state have determined that local taxpayers aren't paying enough in municipal tax obligations and that somehow, when it comes to the demand for local services, that they should come at a higher premium or just be foregone.

To mayors, managers, police and fire personnel, this continued assault on local taxpayers is deeply troubling and seems counterintuitive to the state's desire to create a stable, safe and attractive Ohio for future economic prosperity.

On behalf of the Ohio Municipal League's 735 members representing nearly 9 million residents and workers, we ask that the legislature consider how the policy decisions here at the Statehouse can impede the good work occurring all throughout the state by municipalities striving to provide an environment where businesses can be successful and where citizens can enjoy what Ohio has to offer.

Mr. Chairmen and Commission members, I appreciate the opportunity to testify before you and I would be happy to answer any questions you may have.

THE OHIO STATE UNIVERSITY
JOHN GLENN COLLEGE OF PUBLIC AFFAIRS

Testimony Before the 2020 Tax Policy Study Commission of the Ohio General Assembly

Testimony of
Edward [Ned] Hill, Ph.D.
Professor of Public Affairs and City and Regional Planning
John Glenn College of Public Affairs
The Ohio State University

September 26, 2016
Revised
September 27, 2016

Thank you Chairman Peterson and members of the Commission for the opportunity to testify this afternoon.

My name is Ned Hill, and I am Professor of Public Affairs and City and Regional Planning at the John Glenn College of Public Affairs at The Ohio State University, where I specialize in economic development and public finance. I am also a member of Ohio State University's Ohio Manufacturing Institute where I examine public policies related to manufacturing workforce and innovation.

I am going to discuss four items this afternoon: (1) Ohio's fiscal system, (2) the quality of local government fiscal data, (3) tax revenue and future business cycles, and (4) tax credit programs.

1. Ohio's Fiscal System

A fiscal system is at work in the state of Ohio with the state, counties, municipalities, and special districts collecting taxes and fees and providing services. ***The state of Ohio should thoroughly review the entire state-local government system.*** The review should examine the complete tax structure, its complexity, cost of compliance and the ability of all parts of the system to meet demands for revenue.

Ohio's elected leaders should understand how taxes interact across all levels of government and how taxes and expenditures will behave in future business cycles. We also need to know the impact of the expected fiscal demands of local government, especially those that affect statewide public infrastructure systems, including water and sewer systems, broadband, transportation, and waterways.

2. Quality of Local Government Fiscal Data

There are three barriers to understanding the interactions of the state and local revenue collections and expenditures. First, uniform charts of accounts that are appropriate for each type of local government do not exist. Different charts of accounts need to be developed for counties, municipalities, villages, school districts, and special districts. Second, municipalities use different fiscal years, which makes it difficult to compare performance across districts. Third, different accounting systems are used. Some use Generally Accepted Accounting Principles, or GAP, while others use cash accounting or modified accrual systems. Additionally, reliable information on units of local government does not exist. This poses specific problems for the state in terms of monitoring performance, to investors in local government debt, and to citizens in understanding the operations of their local government.

There are two basic tools used in managing local fiscal performance: benchmarking and historical analysis. Benchmarking revenues and expenditures against peer units of government is essential to understanding operational efficiency. This is also true for examining historical trends in revenues and expenditures. Neither is currently available to the citizens of the state of Ohio due to the lack of a consistent chart of accounts for cities, counties, and special districts. ***Representatives Duffy and Hagan have drafted a bill that addresses parts of this problem.***

I am part of a team at the John Glenn College that has been working with local government fiscal data posted on the Auditor's website. The data are unaudited, and Auditor Yost's staff cautioned us and told us that the data were problematic. We did not listen; we should have.

We found that the data for municipalities were inconsistent, all too often did not agree with the city's Comprehensive Annual Fiscal Report [CAFR], and data quality deteriorated in 2013 and 2014. Two students supervised by Professor Charlotte Kirschner worked at cleaning the data throughout the summer, and Professor Kirschner is continuing the work.

Our conclusion is that statements made from the raw data should recognize the quality of the data. Audited data are typically not required for research, and our statistical tools can deal with random error, but in this case, the raw data are just too unreliable to be used with any degree of confidence.

Auditor Yost and his staff should be applauded for recognizing the data problems and for their efforts to improve the data quality. The 2015 data will become the basis for future audits, providing an incentive to local governments to improve the quality of the numbers they report. The Auditor's staff has been both collegial and forthcoming in advising the Glenn College team, and we thank them.

While data issues do not make for exciting headlines, quality fiscal data are essential to public leaders, civil servants, and the public itself. Between our fragmented perspectives on the state's fiscal system and the inconsistent quality of local fiscal data, we are flying a plane with a broken instrument panel.

3. Tax Revenue and Business Cycles

The Department of Taxation's 2015 Annual Report shows that 40 percent of state tax revenue comes from sales and use tax payments, 35 percent from individual income tax payments, 8 percent from the Commercial Activity Tax and two related business taxes, 7 percent from motor fuels taxes, and a bit more than 6 percent from miscellaneous other taxes. The Governor and Legislature have lowered income tax rates. Some advocates are expressing interest in the state becoming less reliant on income taxes and in shifting the composition of taxes toward consumption taxes.

Public policy in Ohio should pay attention to the performance of states that are either are overly reliant on one source of tax revenue, have cut taxes very aggressively, or shifted to consumption taxation. After looking at the performance of these states it becomes apparent that there is wisdom in both moderation and diversification in the sources of tax revenue.

There are two practical problems with a tax system that becomes overly reliant on taxing consumption expenditure. One is associated with revenue volatility, the other is associated with changes in the income distribution.

Volatility
Personal Consumption Expenditures and Disposable Personal Income behave very differently over the business cycle. Income is more cyclically sensitive, or volatile, than consumption expenditure. The growth, and decline rates, partially offset each other over the course of the business cycle. The data are evidence that a balanced approach to taxation is warranted.

I examined the 12-month percent change in Real Personal Consumption Expenditure and the 12-month percent change in Real Disposable Personal Income for the nation. Both measures were seasonally adjusted. I then calculated a measure of volatility, the Coefficient of Variation, for each at different times over the recent business cycle.

- During the recovery, from January 2010 to April 2016, ***Disposable Personal Income [DPI] was nearly three times more volatile than Personal Consumption Expenditure [PCE]***.
    - The average 12-month percent change was about the same for each (2.2% for PCE and 2.1% for DPI) but the standard error of Disposable Income was twice as large as the standard error of Personal Consumption Expenditure (0.82 for PCE and 1.92 for DPI). The Coefficient of Variation was 0.37 for PCE and 0.91 for DPI.

- ***The results during the Great Recession were of greater concern for fiscal management.***
    - The 12-month percent change in Disposable Personal Income was negative for two-quarters, the quarters that ended in April and October 2009.
    - The 12-month percent change in Personal Consumption Expenditure was negative in six quarters. The mean change in PCE over this period was -0.7 percentage points, while the mean change in DPI was 0.6 percentage points. This is a difference of 1.3 percentage points.

Changes in the income distribution
Nationally the income distribution has changed with income and wealth being increasingly concentrated among the very wealthy. The shift in the income distribution is having negative effects on macroeconomic performance, bearing some responsibility for the sluggish recovery from the Great Recession. The Marginal Propensity to Consume [MPC] is at the root of this problem. The MPC is the fraction of every additional dollar an individual earns that is spent on consumption. Its complement is the Marginal Propensity to Save [MPS]. The split between the MPC and MPS changes

over the income distribution, with the MPS increasing with income. In other words, as income becomes more concentrated at the top of the distribution savings rates increase and rates of consumption drop. ***The implication is that tax revenue will become less elastic if a switch is made from income taxes to consumption taxes.***

The change in the income distribution is also resulting in the globe having a surplus in savings, as indicated by very low rates of return to savings.

4. Tax Credit Programs: A necessary evil

The Commission is examining tax credit programs and it has heard testimony on the economic impact of the Historic Tax Credit program and the New Market Tax Credit program. Both have had a positive impact on the state.

The New Markets tax credit program could become more effective if real estate investors could own the properties. Typically, start-ups and rapidly growing companies invest their funds in their operations, not in buildings. Not only do they want to invest in assets directly related to production, they often expect to have to move as they outgrow their current space.

The downside of any tax credit program is the deadweight loss that is unavoidable in their design. Tax credits are sold to an entity that wants to offset a portion of their tax payments to the state. The instruments would not be sold if the trade was a dollar-for-dollar swap of credits for taxes. The difference, or discount, between the value of the credit and the amount the developer receives at its sale, is the efficiency loss, or deadweight loss. The program would be more efficient if taxes were collected and expenditures made directly from the state's General Fund.

Advocates for the credit programs understand the efficiency loss but doubt the politics of adding the programs to the state's budget. They will also argue that the way the tax credit programs are structured improves their efficiency. Efficiency gains come from two aspects of the program's design. First, the process is very competitive, demand for funding far exceeds supply yielding higher social returns. Second, credits are only issued after the project is completed, ensuring that the funds are not wasted on failed projects. There is merit to this argument.

Thank you for providing me with the opportunity to testify and I look forward to answering any questions that the committee has.

September 23, 2016

The Honorable State Senator Bob Peterson
Co-Chair, 2020 Tax Policy Study Commission
1 Capital Square, Ground Floor
Columbus, OH 43215

The Honorable State Representative Tim Schaffer
Co-Chair, 2020 Tax Policy Study Commission
77 S. High Street, 13th Floor
Columbus, Ohio 43215

Dear Chairman Peterson and Chairman Schaffer:

As the 2020 Tax Policy Study Commission considers ways to maximize Ohio's competitiveness, we wish to express our thoughts on how state tax policy should work to strengthen the economic development capacity of cities and metropolitan regions.

As you may know, 80 percent of the state's GDP is created in our seven largest metropolitan regions. As leaders in the communities within these regions, we are on the front lines of economic development, and as such, have first-hand knowledge of what makes Ohio competitive.

Our experience tells us that competitiveness in attracting new investment to our regions comes from a wide array of factors. Most successful economic development efforts are predicated on having a skilled workforce, access to transportation hubs, and a high quality of life for those starting businesses and their employees. These are the basic building blocks for communities like ours to attract and retain jobs.

Cities are engines for economic growth. However, our ability to serve in this capacity is constrained when state revenue sharing programs are curtailed and municipal tax policy changes result in significant financial impacts on cities. Taking further actions that create more financial hardships for cities will weaken our economic development efforts and undermine our ability to create safe neighborhoods, healthy infrastructure, and a strong workforce.

Thank you for considering our input as you develop your recommendations. We appreciate the opportunity to comment and we hope to work together in our shared goals of creating jobs and fostering broad-based economic growth for Ohio.

Respectfully submitted,

David J. Berger, Mayor
City of Lima

Warren R. Copeland, Mayor
City of Springfield

John Cranley, Mayor
City of Cincinnati

Tim J. DeGeeter, Mayor
City of Parma

Andrew J. Ginther, Mayor
City of Columbus

Kirsten Holzheimer Gail, Mayor
City of Euclid

Paula Hicks-Hudson, Mayor
City of Toledo

Daniel Horrigan, Mayor
City of Akron

Lydia L. Mihalik, Mayor
City of Findlay

John A. McNally, Mayor
City of Youngstown

Steve Miller, Mayor
City of Fairfield

Lawrence P. Mulligan Jr., Mayor
City of Middletown

Don Patterson, Mayor
City of Kettering

Gregory S. Peterson, Mayor
City of Dublin

Richard "Ike" Stage, Mayor
City of Grove City

Mike Summers, Mayor
City of Lakewood

Don Walters, Mayor
Cuyahoga Falls

Nan Whaley, Mayor
City of Dayton

Ohio 2020 Tax Policy Commission
October 31, 2016
Gavin DeVore Leonard, One Ohio Now

My name is Gavin DeVore Leonard. I am the State Director of One Ohio Now, a coalition of 103 partner organizations – health and human service organizations, labor unions, and other advocacy groups – whose members total over 1 million Ohioans. One Ohio Now advocates on state budget and tax policy issues with a focus on ensuring a fair and adequate revenue system to meet Ohio's needs.

I am here today to share our perspective on the Ohio 2020 Tax Policy Study Commission's areas of interest as set out in HB 64, with a particular focus on "the state's tax structure and policies… on how to maximize Ohio's competitiveness by the year 2020." I will also speak briefly to our positions on the other questions before the Commission, including the concept of a "flat tax," reforming Ohio's severance tax, and the review of Ohio's tax credits. My remarks are focused on what I believe to be the overarching question guiding all of the Commission's work: what kind of revenue system should be in place in Ohio to match the state's needs?

There is generally broad agreement that our revenue system should follow basic tax policy principles. Everyone wants the system to be as simple as possible. There is a desire for neutrality so that we are not systematically favoring one kind of economic activity over another and picking winners and losers in the process. And at it's core, the system should be adequate so that the state can maintain the basics so all Ohioans have the opportunity for a great quality of life. State spending on education, infrastructure, and more provides a foundation for a healthy economy.

Prior testimony before this Commission has focused primarily on individual pieces of the revenue system – on the income tax, severance tax, hotel intermediaries, satellite TV, tobacco tax, tax expenditures, and more. I would like to focus on the bigger picture – what is our goal when all of these specific tax policies add up? What does the state need revenue for? Once we've established this purpose, then how much revenue does the state need? Finally, what sources of revenue will help us meet Ohio's needs? These questions are at the root of this Commission's efforts and are why we believe that the basic principle of adequacy should undergird your efforts.

While the state works in concert with federal and local governments, there are certain responsibilities that have typically been expected of the state. While other entities, including the private sector, are clearly instrumental in building strong communities, the state's role is pivotal. The largest needs for state revenues include education, health care, human services, corrections, transportation, and capital needs, in addition to many other areas that are relatively small in the context of the full budget but can be very important to the individuals and entities that receive financial support.

We need revenue for these major areas of investment in Ohio for clear reasons. We want an educated population because we know this leads to a healthy economy and stronger wages for everyone. We want Ohioans to be healthy, to be safe, to be able to travel and move goods easily, and to have a high quality of life in our communities.

Earlier this year, we released a report (The State of Ohio 2016, an addendum to this testimony) that attempted to assess the depth of our needs in Ohio in a holistic way, and to therefore draw conclusions about our revenue needs to match. By looking at metrics across the categories of Health and Home, Education, and Employment and Economy, we sought to share an accurate portrayal of what is happening in Ohio and how we compare to the country. Compiling the data across these broad categories, we found many areas of significant need that we believe impact the question of how much revenue is needed to ensure Ohioans are educated, safe, healthy, and more.

For example, at our report's release, Ohio ranked:

- 34th in college tuition,
- 29th in high school graduation,
- 36th in poverty
- 47th in hunger, and
- 45th in the country for infant mortality,

In many of these areas we saw even greater concerns and notable disparities when looking at the outcomes for children, minorities, and other groups of Ohioans.

Our report makes it clear: we have serious needs in Ohio. To address these needs, we believe that additional state investment will be necessary.

Taking one example, Ohio's college affordability is clearly a major concern. 2/3 of Ohio college graduates are leaving school with debt that averages $29,300. This puts Ohio at a competitive disadvantage to other states. Only 10 states have a higher percentage of students graduating with debt. While a college education is not the only route to a solid income, no one argues that it is a very important piece of the puzzle for Ohioans' long-term success in the economy – individuals need education and businesses need an educated workforce. In fact, by 2020, more than 60% of jobs in Ohio will require an associate's degree or higher.

In order to be competitive, Ohio will need to ensure higher education is attainable for everyone. Yet, Ohio ranked 34th in tuition costs for a full time student at one of Ohio's public colleges or universities. While tuition and State Share of Instruction combine to finance the vast majority of

higher education, it is widely agreed that tuition has simply become too expensive. Therefore, it is hard to imagine a college education system in Ohio that does not more heavily rely on state support. Reducing administrative bloat and other cost cutting can certainly help, but a revenue system to match our higher education needs must be a consideration.

Investing in higher education is simply one of many areas of clear need in our state. Other examples are not hard to find. The need for massive investment in Ohio's infrastructure is undoubtedly great – for roads, bridges, water treatment, internet access, and more. Every legislator knows about the infrastructure needs in their district, but the collective, statewide infrastructure backlog is rarely discussed. High quality pre-k investments show an economic return of $8 for every $1 spent, but too many Ohio kids don't get access to high quality programs. Many local governments and public safety services are seriously struggling. And our poverty rate remains stubbornly high, especially for kids, as 1/3rd of Ohio families earn less than $40,000 per year. All of these areas are calling out for investment – investment that will require a revenue system to match so that Ohio can be competitive on behalf of all Ohioans.

Assuming that we will need additional investment, and revenue, then how much? There is no blanket answer. We'll need to look at each area closely and make tough decisions. Feeding America's report calls for $911 million to end hunger in Ohio. Every child could likely have access to high quality preschool with hundreds of millions of dollars. We could make a serious dent in college affordability – lowering the cost of college education by 20% - with approximately $600 million per year. In other areas, like children's services for those impacted by the opiate epidemic, relatively smaller investments of tens of millions of dollars could make a huge impact.

To meet the principle of adequacy and ensure we can meet our state's many needs, the Commission will want to consider revenue sources. The major sources of revenue for Ohio are income and sales taxes, and the specific question of "how to transition Ohio's personal income tax to a flat tax of three and one-half per cent or three and three-quarters per cent beginning in tax year 2018" is in front of this Commission. We believe in a revenue system that is both adequate and fair. Ohio's annual sales tax revenue is now greater than Ohio's income tax revenue and the proposed transition would further weaken a revenue source that we believe should be strengthened. Therefore, we do not support moving to a "flat tax." Lower income Ohioans already pay a greater share of their income toward state and local taxes than more affluent Ohioans, and a "flat tax" would further exacerbate this discrepancy. Instead, we encourage the Commission to consider how to make our revenue system more equitable while becoming more adequate as well.

One way to move in the right direction would be to increase Ohio's severance tax. This Commission was tasked with considering "how to reform Ohio's severance tax in a way that maximizes competitiveness and enhances the general welfare of the state." In far too many ways, Ohio's revenue system has not kept up with the times, but increasing the severance tax is one common sense improvement so that Ohio can better meet it's needs and spread

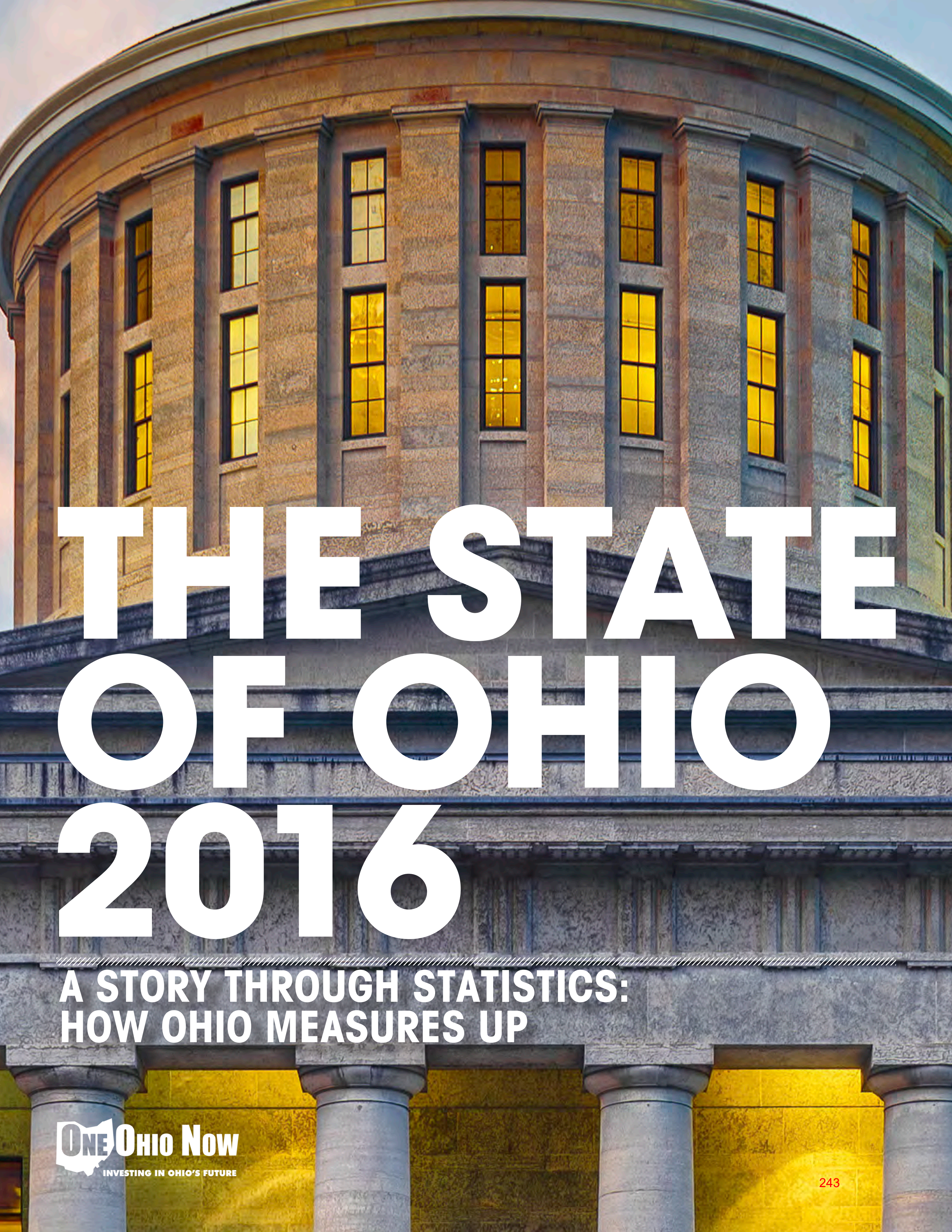
ONE OHIO NOW
INVESTING IN OHIO'S FUTURE

prosperity to everyone, particularly in the communities where oil and gas drilling activity is greatest.

Another Commission goal, to "review and evaluate every credit against a tax levied by the state and authorized in the Revised Code," could lead to common ground for improving Ohio's revenue system. While there are many practical credits, analysis of our nearly $9 billion in annual exemptions leads us to believe at least hundreds of millions of dollars could be returned to the state for investment to solve pressing problems like college affordability. Furthermore, tax credit review will likely lead to increased simplicity and neutrality in the tax code, meeting two more basic principles. We would encourage the General Assembly to reach agreement on House Bill 9, establishing a permanent process for tax expenditure review.

On the final Commission task to review "how to make the tax credit authorized in section 149.311 of the Revised Code more efficient and effective, including converting it to a refundable tax credit or grant program," we do not have a position.

In summary, we appreciate the opportunity to share our perspective with you about how to make Ohio a competitive state where all Ohioans can prosper. We believe that an adequate revenue system is needed to address major needs and we would gladly participate in any further dialogue about how to reach our common goals. I'd be happy to answer any questions you may have.



THE STATE OF OHIO 2016

A STORY THROUGH STATISTICS: HOW OHIO MEASURES UP

ONE OHIO NOW
INVESTING IN OHIO'S FUTURE

EXECUTIVE SUMMARY

This report tells a story about our state, our people, and how we compare to the country. It shows a hard reality: **TOO MANY OHIOANS ARE STRUGGLING.** Deep, stubborn inequality clearly exists. To make all Ohioans' lives better, we'll need serious focus and significant investment aimed at solving our problems.

HEALTH & HOME

EDUCATION

ECONOMY & EMPLOYMENT

INEQUALITY

1 HEALTH & HOME

Infant Mortality	45 th
Hunger	47 th
Home Foreclosure	46 th
Health Insurance	8 th

2 EDUCATION

High School Graduation	29 th
College Tuition	34 th
Pre-K Enrollment	22 nd

3 ECONOMY & EMPLOYMENT

Poverty	33 rd
Median Income	36 th
Unemployment	24 th
Job Growth	27 th

4 INEQUALITY

Black Infant Mortality
Low-Income Graduation
Women's Poverty

Ohio is at or above the national average

Ohio is below the national average

One Ohio Now is a statewide coalition of over 100 health and human service, labor, and advocacy groups. We believe that great public services strengthen our communities and we need revenue to pay for those services.

INTRODUCTION

Like all policy advocates in Ohio, we read a lot of reports. But we realized, nearly every report is narrowly focused on a single issue. THE STATE OF OHIO attempts to synthesize dozens of sources on a range of issues to tell a more holistic story about what's happening in Ohio.

> WE SHOULD HAVE A WAY TO MEASURE OUR SUCCESS AS A WHOLE. THE STATE OF OHIO COULD BE THAT TOOL.

The idea for this report came in 2015. In preparation for the state budget debate, we were reviewing statistics that might indicate how the massive tax shift that began in 2005 was working. We found little to no quantitative evidence to support the repeated narrative: tax changes will lead to prosperity. It became clear that development of a comprehensive yardstick could help Ohio, and this report was born.

In THE STATE OF OHIO, we've settled on 11 wide-ranging areas for measurement that we believe, together, paint a picture of the reality in our state. These metrics fall into the categories of **1) HEALTH & HOME, 2) EDUCATION, and 3) ECONOMY & EMPLOYMENT.** For each metric, we share our big takeaways, look back at trends and policy changes, and look forward based on current affairs. While many of our issues are part of a national reality, or may be solved through local action, as a state-level budget and tax policy coalition we've focused on Ohio.

Too often our political and policy discourse is focused on metrics and rankings that mean little, are hard to understand in context, or are purposefully misleading. We've attempted to use straightforward statistics from trusted sources. There are very important areas we don't include (infrastructure, for example, stands out), but omissions are almost exclusively because there was not a clear quantitative analysis or where we could not compare Ohio with the rest of the country.

There are so many glaring discrepancies in the data we're using based on race, class, gender, and more. We felt it was imperative to include an **INEQUALITY** category. The report concludes with notes about our methodology and citations.

At One Ohio Now, we work to look at the big picture with the public's interest in mind. We are a coalition of over 100 organizations whose total membership includes over 1 million Ohioans. Our coalition was formed because we believe we need fair and adequate state revenues to invest in the public services that give Ohio a chance to be successful.

Since 2005, Ohio has consistently chosen to shift taxes in the name of job and economic growth. That choice now means we have at least $3.5 billion per year less to invest in solving the problems this report details, like skyrocketing college tuition and nearly the worst infant mortality rates in the country. We believe that without significant investment, many of our biggest, most vexing problems – like poverty and job growth – will dog us for decades to come. But we can avoid this fate. Through smart public policy that follows the research, all Ohioans can benefit.

HEALTH & HOME

One thing stands out here: kids need our help.

Our infant mortality and child hunger are staggering and shameful. Ensuring all Ohioans have the basics for Health & Home would lead to stronger communities for everyone. The expansion of Medicaid has clearly had a huge impact for hundreds of thousands of Ohioans. However, to ensure a great quality of life for everyone, we have more work to do on healthcare and many other issues to tackle as well.

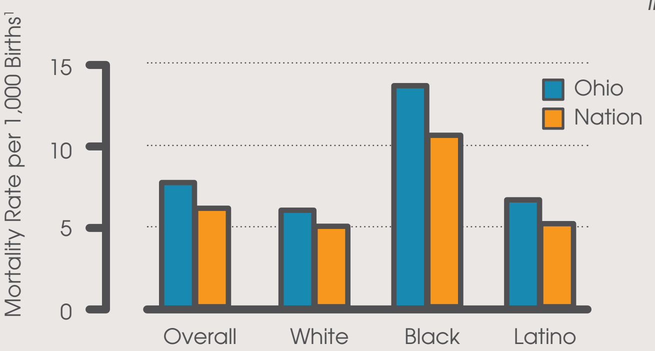
Instead of shifting billions of dollars in tax changes that benefit the wealthy the most, Ohio could make targeted investments and address the systemic problems that impact millions of Ohioans.

INFANT MORTALITY

Infant mortality is the death of children under one year.

45th

in the nation.



WITH AN INFANT MORTALITY RANKING OF 45TH, **OUR NATIONAL RANKING IS ONLY MADE WORSE BY THE STRIKING DISPARITY BY RACE.** BLACK INFANT MORTALITY IS OVER TWICE THAT OF WHITE BABIES (13.6 VS. 6.3 DEATHS PER 1,000).

LOOKING BACK

Premature births (47%), birth defects (14%), unsafe sleeping conditions (15%), and other factors (24%) have contributed to Ohio's high level of infant mortality.[2] Since 2009, infant mortality has become a statewide priority - the goal is to reduce infant mortality to a rate of 6.0 by 2020 for all ethnicities.[3] In the 2016–17 budget, Ohio allocated $2 million toward infant mortality health grants, and the state increased spending on infant vitality by $800,000 a year.[4] These new investments, in addition to Medicaid expansion and other improvements, will hopefully help more babies make it to their first birthday.

LOOKING FORWARD

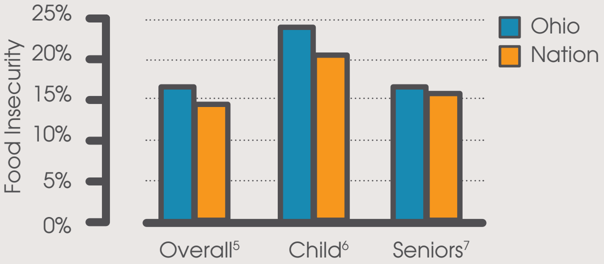
Data for 2014 shows that Ohio's infant mortality rate dropped 8%, however it increased 3.8% for African American children.[2] To meet our goal by 2020, we'll need to do more. Small investments go a long way to ensuring our children survive so they can thrive, but we are concerned the state is simply not doing enough.

HUNGER

A person is food insecure (hungry) if they are without reliable access to a sufficient quantity of nutritious food.

47th

in the nation.



NEARLY **1 IN 4 KIDS SUFFER FROM HUNGER** IN OHIO.[6] WE ALSO HAVE THE 12TH HIGHEST SENIOR HUNGER RATE IN THE NATION.[7] OHIOANS WERE 18% MORE LIKELY TO BE HUNGRY THAN THE NATION WITH NEARLY 17% OF OHIOANS EXPERIENCING HUNGER.

LOOKING BACK

Nationally, food insecurity has declined since the height of the recession (2009–2011) by 2.7%, but it increased by 9% in Ohio. Since 2002–2004, the rate of hunger nationally has increased about 25% and in Ohio by over 48%.[5] Recent budget increases for food banks will help alleviate an immediate crisis for some families, but are still insufficient. As Ohio's economy has changed, we now have more low-wage jobs that leave people in a position of having to choose between healthcare, housing, and food.

LOOKING FORWARD

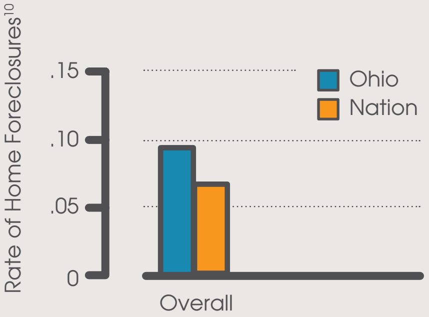
Feeding America estimates it would cost about $885 million to end hunger in Ohio,[6] less than the amount of revenue we lost as a result of the most recent round of income tax cuts.[8] Especially since we know that Investments in food security have a positive economic impact - helping grocery stores, farmers, and ensuring a healthy workforce - ending hunger is something we can and should do.[9]

HOME FORECLOSURE

The number of mortgaged homes where homeowners are unable to make their payments.

46th

in the nation.



EVERY OHIOAN DESERVES SAFE, DECENT, AND AFFORDABLE HOUSING. TOO MANY OHIOANS HAVE LOST THE SECURITY OF A HOME WITH 1 IN EVERY 1,017 HOMES IN OHIO CURRENTLY IN FORECLOSURE.

LOOKING BACK

Ohio continues to climb out from underneath the fallout from the sub-prime mortgage crisis that caused the recession in 2008. In 2006, foreclosures in Ohio were up 320% compared to a decade earlier – largely a result of sub-prime mortgage lending in Ohio.[11] Since 2005, homeownership rates in Ohio have fallen about 8.2%.[12] In some neighborhoods, foreclosures have increased the demand for rental units. Although rents remain affordable compared to the country – about 27% below the national average – they're still out of reach for anyone who earns less than $14.13 an hour. It is even worse in central Ohio, where a person must earn $15.60 to afford an apartment.[13]

LOOKING FORWARD

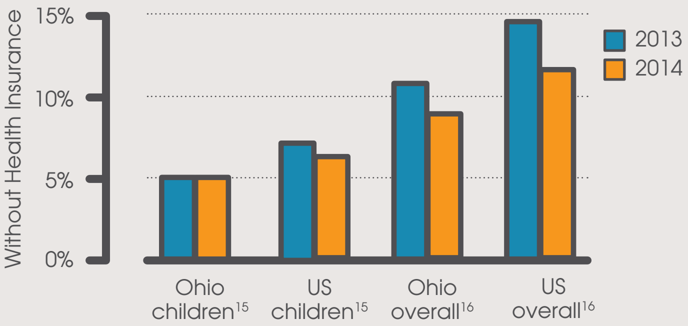
Incomes in Ohio today simply aren't enough to ensure that everyone can afford to purchase a home or rent an apartment. But through smart investments in affordable housing development and service delivery, Ohio can rehab old homes, create more affordable housing, and end homelessness. States like Utah, for example, are trying innovative strategies like providing housing directly to homeless individuals – and it's working.[14]

HEALTH INSURANCE

The percentage of the population in Ohio that has public or private health insurance.

8th

in the nation.



FOLLOWING MEDICAID EXPANSION, OHIO SAW A 24% REDUCTION OF UNINSURED OHIOANS IN JUST 1 YEAR COMPARED TO A NATIONAL REDUCTION OF 19%. IN 2014, THERE WERE 955,000 OHIOANS — OR 8.4%— WITHOUT HEALTH INSURANCE COMPARED TO 11.7% NATIONALLY.

LOOKING BACK

The federal passage of the Affordable Care Act (Obamacare) in 2010 has decreased the uninsured population in Ohio and across the nation, with the most notable changes beginning in 2014. The overall population without health insurance decreased in Ohio from 11 to 8.4% – largely thanks to Governor Kasich's embrace of Medicaid expansion in 2013.[16]

LOOKING FORWARD

Healthcare will likely remain a politically hot topic during 2016 and beyond, particularly as Ohio's share of Medicaid expansion costs begins in 2017. Medicaid represents about 4% of Ohio's economy, insures 45% of Ohio's children, and covers about half of all births in the state.[17] Even with recent improvements, concerns have been raised about access to doctors and care for those who now have insurance. While Ohio data does not exist, nationally, 20% of Americans live in a community without enough primary care doctors, and 30% of Americans live in communities without enough mental health practitioners.[18] Ohio is still at nearly the bottom (47th) in health outcomes, even after Medicaid expansion.[19] We should make investments so that every single Ohioan is insured and has access to the healthcare they need.

EDUCATION

We should strive to be #1 in public education.

There is virtually no disagreement that a great education system is imperative for a strong economy and meaningful opportunity for all. Businesses consistently cite an educated workforce as a top priority. Wage growth is linked to educational attainment, but it will take serious investment to ensure our public education system prepares all of our children for the 21st century.

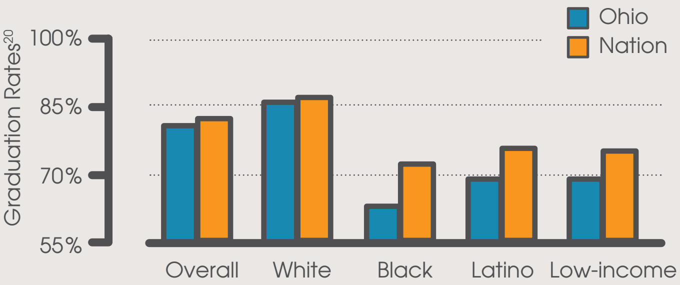
It's clear that calls to improve adequacy and equity are still warranted, especially as we see such great disparities in outcomes based on both race and class. By now, Ohio could have made pre-K available for all Ohioans and substantially reduced the cost of a college education. Instead, we've pursued a trickle-down tax strategy and results have not materialized.

HIGH SCHOOL GRADUATION RATE

The main metric used to track student achievement of public, 4-year high schools.

29th

in the nation.



OHIO'S TOTAL GRADUATION RATE OF 81.8% IS JUST BELOW THE NATIONAL AVERAGE OF 82.3%. **BUT AFRICAN AMERICAN STUDENTS GRADUATE AT JUST 62.7%, LEAVING US 46TH IN THE COUNTRY.**

LOOKING BACK

Over the past few years, Ohio has been within 1% of the national average for our graduation rate, but we continue to struggle with unequal educational opportunities and outcomes. The Ohio Supreme Court has ruled four times that our funding system is inadequate and lacks equity.[21] Still, students from districts that are economically disadvantaged have a graduation rate of only 74%, while wealthy districts have a graduation rate of 97%.[22] Consistent funding changes, new mandates, and more have made it hard to expect consistent success.

LOOKING FORWARD

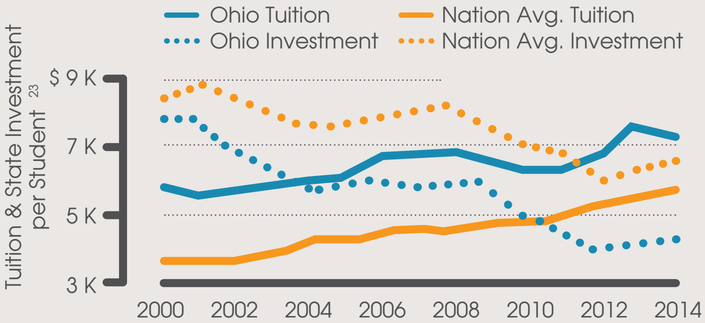
Ohio needs to prioritize state level investment into public education in large urban areas as well as rural communities. Currently, students in wealthy districts benefit from more opportunities than students in poor districts. For example, 60% of students in wealthy districts take an Advanced Placement course, while only 10% of students from districts with economic disadvantage do.[22] Ensuring all Ohio's students have the opportunity to be successful will require equity and adequacy in school funding for every corner of our state.

COLLEGE TUITION

The average cost of a full-time education at Ohio's public colleges and universities.

34th

in the nation.



OHIO'S OVER 40,000 STUDENTS PAY AN AVERAGE OF ABOUT 30% MORE THAN THE NATIONAL AVERAGE FOR COLLEGE. OUR AVERAGE ANNUAL TUITION IS $7,548 COMPARED TO $5,777.

LOOKING BACK

Public colleges and universities are financed primarily by 1) state investment into systems of higher education and 2) tuition paid by students and their families. Ohio has drastically cut our investment per student in higher education. Since 2000, Ohio has cut state investment by more than 43%. A similar trend has occurred nationally, but not to the same extent, with only a 25% reduction.[23] At the same time, Ohio students have seen a 38% increase in tuition. Ohio has also cut back on need-based assistance by 64% between FY 2008 and FY 2015.[24]

LOOKING FORWARD

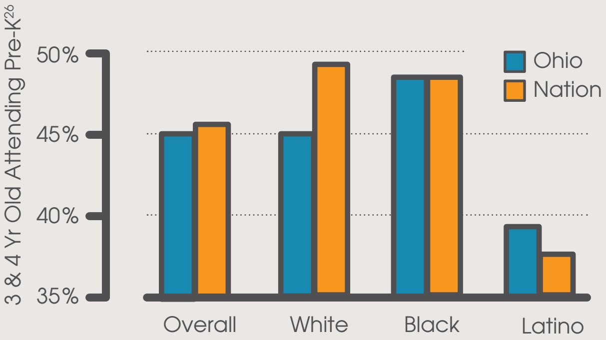
College affordability has become an issue of concern at the Ohio Statehouse, and that is unlikely to change anytime soon. Since 2013, Ohio tuition has been reduced by 1.8% compared to a national average increase of 2.7%.[23] This is a start, but Ohio's investment in higher education in FY 2017 will be $500 million below FY 2008 levels.[24] The state should address the chronic under-funding of higher education, as well as the misplaced spending priorities – most notably on bloated administration.[25]

PRE-K ENROLLMENT

3 & 4 year olds enrolled in a class providing educational experiences for children before kindergarten.

22nd

in the nation.



FROM 2011–2013, 45% OF OHIO CHILDREN ATTENDED PRESCHOOL. OHIO IS TIED WITH THREE OTHER STATES, **PUTTING US IN THE MIDDLE OF THE PACK NATIONALLY FOR PRE-K ENROLLMENT.**

LOOKING BACK

Ohio established its public preschool program in 1990, but legislators have never funded it at a level that would allow every student to access preschool in Ohio. Children can access preschool in Ohio through programs administered by local school districts, Head Start, or through private preschools including daycare centers.[27] To put Ohio in context, enrollment in last place Nevada is 31%, while top-ranked Connecticut has 63% of students in pre-K.[26]

LOOKING FORWARD

Ohio increased spending by $15 million or 33% in the 2014–15 school year, moving us to 27th for preschool spending. This should be an ongoing priority. Michigan for example, spends $243 million compared to Ohio's $60 million.[28] When children enter kindergarten at very different levels, it slows the progress of the entire class. Investments in early childhood education are a smart public investment that will strengthen our communities and our economy in the long run.

ECONOMY & EMPLOYMENT

Our economy shows some positive signs, but overall far too many Ohioans are slipping through the cracks.

As the national economy has improved post-Great Recession, so too has Ohio's. Unfortunately, we've underperformed the country on important metrics like job growth. Plus, the jobs we are creating are increasingly low-wage jobs that leave people struggling to get out of poverty.[29]

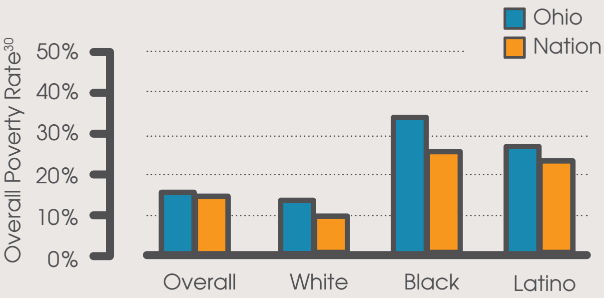
By far the biggest strategy for economic growth over the past 10 years has been income and business tax cuts that benefit the wealthy the most. Too many Ohioans now actually pay more as we've shifted to sales and other regressive taxes. We must beware of talk about economic growth without proof that this strategy is working. Shared prosperity across, race, gender and other lines should be our goal.

POVERTY

Poverty is defined as a family of four earning less than $24,250.

33rd

in the nation.



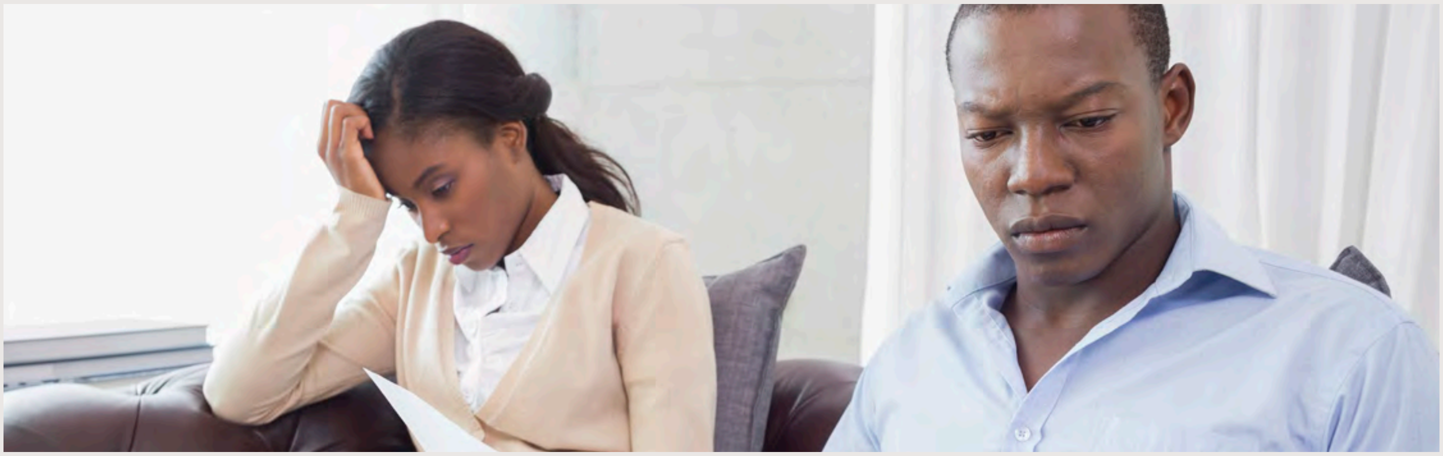
15.6% OF OHIOANS – OR 1.8 MILLION PEOPLE – LIVE IN POVERTY COMPARED TO 14.8% NATIONALLY. POVERTY DISPROPORTIONATELY IMPACTS RACIAL MINORITIES IN OHIO. FOR EXAMPLE, 33% OF AFRICAN AMERICANS IN OHIO ARE IN POVERTY COMPARED TO 26% NATIONALLY.[31]

LOOKING BACK

Our poverty rate in 2001 was 11.9% before rising 38% to 16.4% in 2011.[31] Even after a slight improvement since then, we're trending in the wrong direction. An additional 19% of Ohioans are on the brink of poverty (below 200% of the poverty level)[32] which adds up to over 4 million Ohioans in economic distress. The trends are worse for children. Currently, 23% of Ohio's children are in poverty – up 43% since 2001.[33] Ohio's African American child poverty is the worst, currently at 48%.[34]

LOOKING FORWARD

New jobs in Ohio are increasingly low wage-jobs, leaving many working individuals in or near poverty.[29] Until a job means a living for every Ohioan, we need public investments to help families survive day-to-day, including public transportation, affordable housing, health care and more. Ohio should prioritize proven programs like Ohio's Earned Income Tax Credit (EITC) that will lift many families out of poverty.

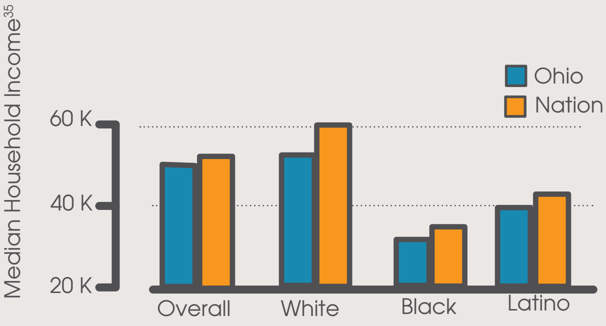


MEDIAN INCOME

Median household income is the halfway point of income. Half of households earn more, half earn less.

36th

in the nation.



THE MEDIAN HOUSEHOLD INCOME IN OHIO IS $49,664 A YEAR – 7.4% BELOW THE NATIONAL AVERAGE OF $53,657.

LOOKING BACK

Ohio continues to struggle with declining incomes. In 2000, Ohio ranked 19th in the nation for median household income, now we rank 36th. Since 2000, the national median income has dropped 7%, but Ohio has fallen 16%.[35] This change is widely attributed to a loss of 368,500 quality manufacturing jobs since 1998.[36]

LOOKING FORWARD

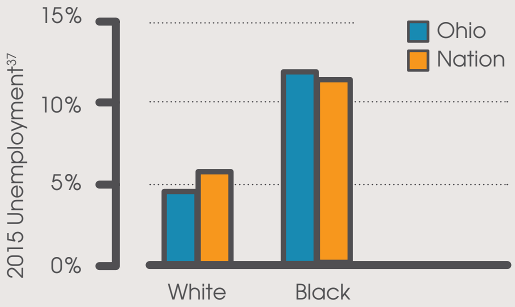
11 of the 12 fastest growing job categories in Ohio pay a lower median income than Ohio's median income. These 12 categories represent about 1.1 million jobs.[29] Tax changes have consistently benefited businesses and high-income Ohioans, but the wealth has not trickled down. Identifying other solutions – such as a higher minimum wage or living wage laws – could also help Ohio take meaningful steps forward in making sure every Ohioan earns enough for a great quality of life.

UNEMPLOYMENT

Unemployment is calculated by the ratio of people not employed who are in the labor force.

24th

in the nation.



OHIO'S UNEMPLOYMENT RATE AT THE END OF 2015 WAS 4.8%. THIS IS BELOW THE NATIONAL UNEMPLOYMENT RATE OF 5.0%.

LOOKING BACK

Ohio's unemployment rate has fallen from a high of 11.0% in December of 2009, but since the recession the workforce participation rate has remained low - below 63% - and it fell last year.[38] The declining workforce is a negative sign that our unemployment rate might be artificially low. African Americans in Ohio have an unemployment rate of 11.9% - nearly 3 times the unemployment rate for white Ohioans.[38] The national unemployment rate for African Americans is slightly less than Ohio at 11.3%.[39]

LOOKING FORWARD

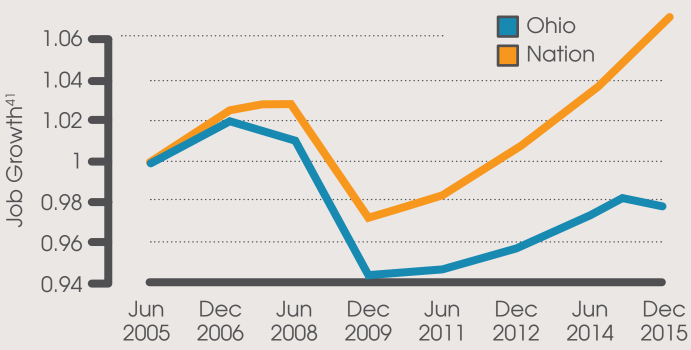
Ohio's unemployment rate ticked up at the end of 2015 (from 4.5% to 4.7%) while creating 15,000 jobs and an increase in the workforce by 16,000 people.[40] Ohio needs more months to follow this trend – an increase in the number of people within the labor force actively seeking work. While this may lead to a higher unemployment rate, it would be a positive sign that Ohio's economy is recovering. In addition to improving the quality of life for all Ohioans, significant public investments in infrastructure, education, and other public services would also have a positive impact on our unemployment rate.

JOB GROWTH

The rate of new jobs added or subtracted from the economy.

27th

in the nation.



OHIO HAD A JOB GROWTH RATE OF 1.5% COMPARED TO A NATIONAL AVERAGE OF 1.8% IN 2015 - GIVING OHIO A RANK OF 27TH.[42] **WE HAVE BEEN CONSISTENTLY UNABLE TO MATCH THE NATIONAL AVERAGE.**

LOOKING BACK

In 2005, Ohio passed a major tax package that cut state income taxes by 21%, raised the sales tax, and more – the main goal was to create jobs. But, as of December 2015, Ohio remained about 91,000 jobs below June 2005. After 10 years, Ohio is doing worse than the nation in terms of job growth. Since 2005, Ohio has lost 1.6% of our jobs and the country had a growth rate of 7%.[41]

LOOKING FORWARD

In addition to the total number of jobs, we should look at the quality of the jobs being created in Ohio. With the decline in manufacturing and the rise of the service sector, Ohio has lost a lot of good paying jobs for minimum wage jobs.[29] We could restore good paying jobs with smart public investments like fixing aging sewer lines, cleaning up polluted rivers, and re-hiring public school teachers to help prepare children for the future. 10 years of income tax cuts and other tax shifts have not delivered the promised jobs – it is time for Ohio to try something else.

* 2015 Data is based on most recent economic revisions at the time of printing, knowing that the Bureau of Labor Statistics makes periodic revisions to data.

INEQUALITY

Racial minorities, women, LGBTQ people, and other groups are consistently underperforming Ohio and the United States as a whole.

We cannot expect time to naturally heal the disparities that exist in Ohio and the nation around **health & home, education, and employment and the economy**. We must acknowledge the challenges of inequality and identify public policies that can be modified to provide all Ohioans a fair shot at success.

Our goal should be for everyone in Ohio to succeed, period – regardless of race, class, gender, sexual orientation, age, religion, ability, or any other characteristic used to divide us. To accomplish this, we need smart public investments that strengthen all of our communities and not pit one community against another.

HEALTH & HOME INEQUALITY

MAJOR DISPARITIES EXIST IN BASIC QUALITY OF LIFE AREAS. HERE ARE A FEW EXAMPLES:

HOME OWNERSHIP RATES AND RATES OF RETURN DIFFER BASED ON RACE

Nationally in 2011, 45% of African Americans owned their own homes compared to 73% of white Americans. The economic return on homeownership also is different based on one's race. Every $1.00 of wealth accumulated through homeownership by African Americans translated to $1.34 for white families.[43] This inequality prevents wealth-building through home ownership, which is often passed on to the next generation.

SEXUAL ORIENTATION DISCRIMINATION IN HOUSING, EMPLOYMENT, AND MORE

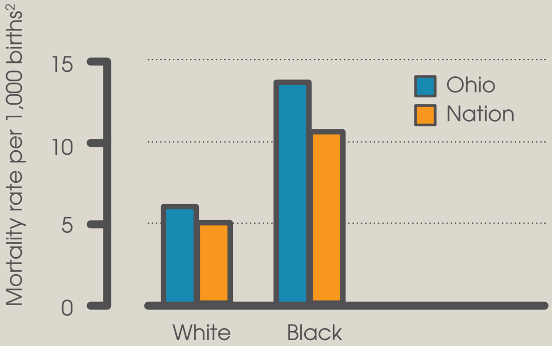
Individuals in Ohio who are LGBTQ continue to face legal discrimination in Ohio based on their sexual orientation and identification. Ohio continues to allow this discrimination in housing and employment. HUD published the first report in May of 2013 on this subject,[44] and it is one of many areas where the state should strive to better understand how inequality is playing out.

SPOTLIGHT ON

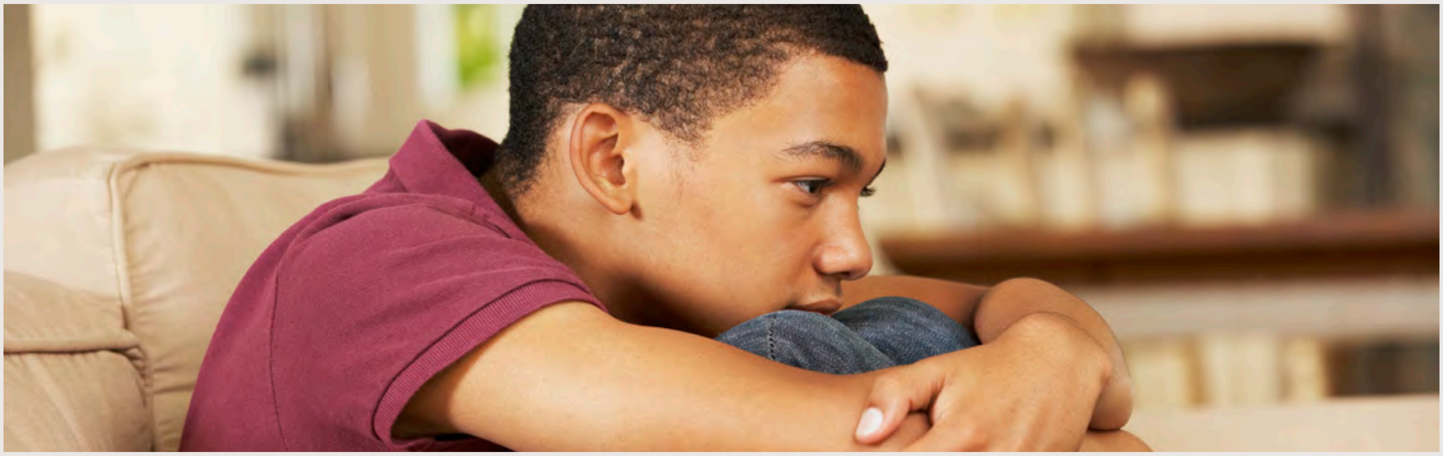
AFRICAN AMERICAN INFANT MORTALITY

38th out of 40

in the nation of states reporting African American Infant Mortality.



In 2014, Ohio's African American infant mortality rate was 170% greater than that of Ohio's white children,[2] and Ohio's African American infant mortality rate was 20% greater than the national average. Of states with data reported, only Kansas and Wisconsin had a higher infant mortality rate among African Americans than Ohio.[1] Ohio's goal by 2020 is to reduce infant mortality for all races to a rate of 6.0.[3] This is a sad example of how far we have to go to achieve equality.



EDUCATION INEQUALITY

OUTCOMES FOR BLACK AND LOW-INCOME STUDENTS ARE JUST SOME OF THE DIVIDES WE SEE IN EDUCATION. EXAMPLES INCLUDE:

OHIO'S AFRICAN AMERICAN GRADUATION RATE IS NOTABLY LOW

For the 2013–14 school year, Ohio's African American students were 24% less likely to graduate from high school than their white counterparts, and 10% less likely to graduate from high school than African Americans in the nation (72.5% to 62.7%). Only 4 states and Washington DC had a lower African American graduation rate.[20]

THE VALUE OF A COLLEGE DEGREE DEPENDS ON THE COLOR OF YOUR SKIN

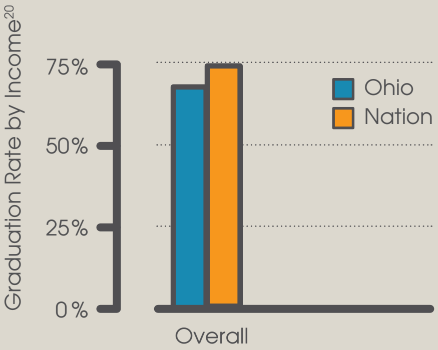
A white worker is 41% more likely to earn a bachelor's degree than an African American.[43] The economic return on that degree is also unequal. A white worker will earn 23.5% more than an African American when both have bachelor's degrees. Among workers with only a high school education, the median wage of a white worker is 16% higher than the median wage for a black worker.[38]

SPOTLIGHT ON

GRADUATION RATE BY INCOME

36th

in the nation.



Ohio ranks 36th for graduation rate among economically disadvantaged students (69.2%) compared to our overall graduation rate of 81.8%. The national average for economically disadvantaged students is 74.6%.[20] It is said that an education is the key to eradicating poverty, but how can we eradicate poverty through education when you need income to graduate?

ECONOMY & EMPLOYMENT INEQUALITY

INEQUALITY IN OUR ECONOMY IS BECOMING HARDER AND HARDER TO IGNORE. HERE ARE SOME OF THE AREAS WORTH A SECOND LOOK:

RACE AND MEDIAN WAGES.

In 2014, the median wage of African Americans in Ohio was $12.81 an hour compared to $16.87 for whites — a difference of about 32%. However, in 1979, that same gap was only about 10%. Since 1979, the median wage of African Americans has fallen 20% compared to a drop of 3.7% for whites.[38] So, while the median wage for white Ohioans has declined some over the past generation, it is a much smaller decline than the drop for African Americans.

JOB GROWTH IS UNEQUAL.

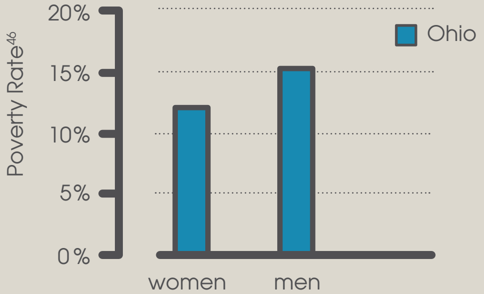
Among African Americans, job growth has remained sluggish. The African American unemployment rate is 11.0% compared to 4.3% for white Ohioans. Ohio has the 8th worst African American unemployment rate in the nation, and an African American Ohioan is 156% more likely to be unemployed than a white Ohioan.[45]

SPOTLIGHT ON

WOMEN'S POVERTY

28th

in the nation.



Ohio has the 28th lowest poverty rate for women and women are 32% more likely than men to live in poverty. Women continue to face discrimination in the workplace, despite obtaining more bachelor's degrees since the 1980s.

METHODOLOGY

OUR EXECUTIVE SUMMARY RANKING SYSTEM: THUMBS

A thumbs up (👍) was given for national rankings where Ohio performed better than half of the states. A thumbs down (👎) was given when Ohio was below the national average. However, settling for middle of the pack should not be acceptable on many of these indicators. We are disappointed when The Ohio State University football team is ranked 25th, we should not settle for a similar ranking for things as important as high school graduation or poverty rates.

WHY THESE METRICS?

The data points selected from the hundreds of possibilities attempted to address issues that everyday Ohioans see and feel - quality of life issues that impact all of us and should be the way we know if our state is being successful. People wonder if they'll be able to afford a home, if our neighbors have enough to eat, and what is happening with our schools. These statistics are by no means completely inclusive of all the intricacies of data that reflect on a particular issue. These metrics are intended to paint a "big picture" view of Ohio. Also, as noted in the Executive Summary, we sought metrics that would allow us to put Ohio in context with the country.

NOTES ON THE DATA USED

Data can be used to shed a lot of light or to confuse and mislead the reader. With the data points selected, we attempted to demonstrate the most basic definition with the most commonly used statistic on that measure. Definitions of the statistic are incorporated into each page to explain what the statistic means. For some measures, Ohio and other states differ slightly or changes indicated over time might be small. Most data sets we referenced indicated the level of statistical confidence and statistical significance in their footnotes. If you are looking for a more mathematical understanding of these data points, we encourage you to look to the original data sources for their analysis.

WHAT IS A YEAR?

Because of calculation limitations, some annual data is released toward the end of the following year. So, while data may say 2014, it is the most current data available. Other data sets are averages over a period of time (such as 2011–2014). This is often done to avoid statistical anomalies that can occur in a given snapshot. To the best of our ability, we compared similar time frames. Three main years are used in this data and mentioned throughout: Ohio's fiscal year (July 1–June 30), the calendar year (January 1–Dec. 31), and the school year (August–June).

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This report is available online at http://oneohionow.org/state-of-ohio-2016. The sources for all of the data are listed below. In addition to the full reports, the data tables used for the national rankings have been pulled out and are listed on the website for easy access and comparison.

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We would like to thank the individuals and organizations who provided support, including:

One Ohio Now Steering Committee members

Graphic Designers Vera Soper & Jared Raines

All of the organizations, reporters, and government agencies who provided us with source data, including the over 100 endorsing partners of our coalition:

- ACTION OHIO: Coalition for Battered Women
- AFSCME Ohio Council 8
- AIR Inc.
- All Aboard Ohio
- America Votes Ohio
- Asian Services in Action (ASIA Inc.)
- Center for Working Class Studies – Youngstown State University
- Children's Defense Fund – Ohio
- Cleveland Jobs with Justice
- Cleveland Tenants Organization
- Clintonville Beechwold Community Resource Center
- Clintonville for Change
- Church for All People
- Coalition on Homelessness and Housing in Ohio (COHHIO)
- Common Cause Ohio
- Communications Workers of America (CWA)
- Columbus Jobs with Justice
- Columbus Metropolitan Area Church Council
- Community Action Partnership of the Greater Dayton Area (CAP)
- Community Partners for Affordable Accessible Health Care (CPAAHC)
- Corporation for Ohio Appalachian Development (COAD)
- Ecumenical Communities for a Compassionate Ohio (ECCOHIO)
- Education Service Center of Lake Erie West
- Empowering and Strengthening Ohio's People (ESOP)
- The Empowerment Center of Greater Cleveland
- Environmental Health Watch
- Equality Ohio
- Findlay Hope House for the Homeless, Inc.
- Forging Responsible Youth
- Georgetown Federation of Teachers
- Greater Cincinnati Coalition for the Homeless
- Greater Hilltop Area Shalom Zone
- Havar, Inc.
- Hispanic Alliance, Inc.
- The Hunger Network in Ohio

IUE-CWA
Innovation Ohio
Legal Aid Society of Southwest Ohio
LiveCLEVELAND!
Lutheran Metropolitan Ministry (LMM)
Mahoning Valley Organizing Collaborative (MVOC)
National Association of Social Workers (NASW) Ohio Chapter
Neighborhood Solutions, Inc.
Northeast Ohio Alliance for Hope (NOAH)
Northeast Ohio American Friends Service Committee
Northeast Ohio Coalition for the Homeless
Northern Ohioans for Budget and Legislation Equality (NOBLE)
Ohio AFL-CIO
Ohio Alliance for Retired Americans
Ohio Association of Community Action Agencies (OACAA)
Ohio Association of Free Clinics
Ohio Association of Professional Fire Fighters (OAPFF)
Ohio Association of School Business Officials (OASBO)
Ohio Community Development Corporation (CDC) Association
Ohio Civil Service Employees Association (OCSEA) Local 11/AFSCME
Ohio Coalition for Equity and Adequacy of School Funding
Ohio Communities United
Ohio Conference of the American Association of University Professors (AAUP)
Ohio Conference of the National Association for the Advancement of Colored People (NAACP)
Ohio Conference on Fair Trade
Ohio Congress of Parents and Teachers (Ohio PTA)
Ohio Domestic Violence Network (ODVN)
Ohio Education Association (OEA)
Ohio Environmental Council
Ohio Farmers Union
Ohio Federation of Teachers (OFT)
Ohio National Organization for Women (NOW)
Ohio Organizing Collaborative (OOC)
Ohio Partners for Affordable Energy (OPAE)
Ohio Poverty Law Center
Ohio School Boards Association (OSBA)
Ohio Student Association (OSA)
Ohio Voice
Ohio Voter Fund
Ohio Votes
Ohio Youth Voices
Organize! Ohio
Over-the-Rhine Community Housing
People's Empowerment Coalition of Ohio (PEC)
Planned Parenthood Affiliates of Ohio
Policy Matters Ohio
Putting People First
ProgressOhio
Rahab's Hideaway
Results Cincinnati
Results Columbus
Service Employees International Union (SEIU) District 1199
Service Employees International Union (SEIU) Local 1
Tapestry
Toledo Jobs with Justice
UHCAN Ohio
United Food and Commercial Workers (UFCW) Local 1059
United Food and Commercial Workers (UFCW) Local 75
The University of Akron AAUP
We are the Uninsured
We Believe Ohio
Working America
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Testimony to the Ohio 2020 Tax Policy Study Commission

October 31, 2016

Chairmen Peterson and Schaffer and members of the Commission, good morning.

My name is Chris Nichols and I am the Director of Management & Budget for the Stark County Commissioners and in my "spare" time, I am also a Canton Township Trustee. I would like to thank you for the opportunity to address the Commission this morning, on behalf of the citizens of Stark County and the County Commissioners Association of Ohio, regarding the impending elimination of sales tax collections from Medicaid MCO's, beginning in July of 2017.

Stark County Sales Tax History

I would like to begin by providing some background on county sales taxes in Stark County. As our local legislators are well aware, Stark County has a colorful history when it comes to our County Sales Tax. Over the past 31 years since our first County Sales Tax was implemented, we have had a County Sales Tax imposed by the Board of Commissioners on 3 separate occasions, only to have the voters of Stark County repeal those County Sales Taxes, all 3 times. We have had a County Sales Tax approved by the voters and then not renewed when its initial term had expired and we have had 3 multi-year gaps, when no County Sales Tax has been in place at all.

The current Stark County Sales Tax is an 8-year, 0.50% tax, approved by county voters in 2011, which is dedicated to supporting our Criminal Justice System. Stark is one of only 2 counties, Mahoning being the other, who have a County Sales Tax where the revenue is restricted to only supporting Criminal Justice activities, instead of all the revenue being directed to the county's General Fund, to be used for any lawful county expense. Actually, in Mahoning County they have multiple County Sales Taxes, which include two separate 0.50% County Sales Taxes that provide a total of 1.0% to their General Fund and an additional 0.25% County Sales Tax, which is restricted to Criminal Justice activities. In Stark County, the only County Sales Tax benefitting County government is the 0.50% Justice System Sales Tax.

Medicaid MCO Tax Exemption

So, what does the impending change, exempting Medicaid MCO's from sales tax collection mean to Stark County and the other counties around Ohio? According to the attached report (Exhibit A), prepared by the Ohio Department of Taxation, Stark County stands to lose almost $1.9 million or 6.5% of our annual Justice System Sales Tax revenue. The total additional revenue loss to the other counties around our state is expected to be in excess of $146 million (7.5% of their cumulative sales tax revenues) per year, according to the same report. Regional Transit Authorities around the state, including our transit authority in Stark County, SARTA, are also expected to lose in excess of $33.5 million per year, from their operating budgets.

Again, in Stark County the revenue from our sales tax is restricted to Criminal Justice activities only. This 6.5% loss of Justice System Sales Tax revenue will most certainly impact the Criminal Justice system in Stark County, which consists of; the Sheriff and County Jail, all of our County Courts, Prosecutors Office, Public Defender, Clerk of Courts, Coroner, Assigned Counsel, along with mandatory contributions to the County's Municipal Courts, 5th District Court of Appeals and the Multi-County Juvenile Attention System. The 6.5% revenue loss from our sales tax also then leads to a drop of almost 3.0% in total available revenue for Stark County to fund all other current county operations. Similar financial impacts will be felt in every county around Ohio, from Adams to Wyandot Counties.

Stark County is "fortunate", in that our expected revenue loss should only be about 6.5%. As you will see in the report from the Ohio Department of Taxation, almost 1/3 of Ohio's counties (27 of 88) will see County Sales Tax revenue loses in excess of 10.0%, with Vinton County expecting a revenue loss of 24.9%, almost a quarter of their County Sales Tax revenue.

Potential Other Related Revenue Losses

As the Budget Director for the Stark County Commissioners, I am also concerned there will be two more "shoes to drop" relating to this same issue, which will have additional negative impacts on the finances of Stark and Ohio's other counties:

1. Ohio's Sales Tax Revenue is also estimated to be negatively impacted by about $550 million per year, according to the attached estimate (Exhibit B) developed by the Department of Medicaid. Since State Sales Tax revenue is a component of Ohio's General Revenue Fund, of which the Local Government Fund formula is applied against, it should be expected that a reduction of Local Government Funds will be seen due to the drop in State revenues.
2. As the State looks to "cover" that $550 million revenue loss, will there be additional significant reductions in the Local Government Fund formula, at the further expense of Ohio's counties and other local governments?

Local Government Fund and Other Revenue Reductions

I'm sure our legislators and state leaders are tired of hearing from Ohio's political subdivisions about the cuts that have been made in various local government revenues over the past years, primarily due to items contained in recent State budgets. Unfortunately, the reason State leaders continue to hear about them is because those cuts have had a dramatic effect on the budgets of almost every county and political subdivision in our state and in many cases, disproportionate effects between subdivisions.

It seems that with each budget cycle, there is another hit to the revenues of Ohio's Counties and political subdivisions:

- Phase out of the Tangible Personal Property Tax
- Elimination of the Estate Tax
- Public Utility Property Tax Reduction
- 50% Reduction in Local Government Fund Formula

These changes, combined with local factors taking place simultaneously during the recession such as declining property tax collections, interest income and conveyance fees, as examples, have made budgetary stability for counties very challenging.

Casino Tax Revenue

Ohio's counties have been able to replace some of that lost revenue by being the recipients of 51% of the Casino Tax, which began to be collected in 2012 following the opening of Ohio's four casinos. Unfortunately for Stark County and most of Ohio's larger counties, we have not been able to realize the full benefit of the County share of the Casino Tax. The Casino statute states that if the most populous city in a county had a population over 80,000 during the 2000 Census, then that city must receive 50% of the county's share. While representing only 19.2% of Stark County's population, because it met those criteria, the City of Canton receives 50% of Stark's Casino Tax revenue. As the following table shows, this requirement disproportionately penalizes Stark County along with most of the other large counties in the state.

County Name	County Population 2015	Most Populous City	City Population 2015	City % of County Population	CY2016 Total City Distribution	CY2016 Total County Distribution
Cuyahoga	**1,255,921**	**Cleveland**	**388,072**	**30.9%**	**$ 7,433,507**	**$ 7,433,507**
Franklin	1,251,722	Columbus	832,022	66.5%	$ 7,372,823	$ 7,372,823
Hamilton	**807,598**	**Cincinnati**	**298,550**	**37.0%**	**$ 4,774,840**	**$ 4,774,840**
Lucas	433,689	Toledo	279,789	64.5%	$ 2,567,272	$ 2,567,272
Mahoning	**231,900**	**Youngstown**	**64,617**	**27.9%**	**$ 1,373,424**	**$ 1,373,425**
Montgomery	**532,258**	**Dayton**	**140,599**	**26.4%**	**$ 3,149,132**	**$ 3,149,132**
Stark	**375,165**	**Canton**	**71,885**	**19.2%**	**$ 2,219,634**	**$ 2,219,634**
Summit	**541,968**	**Akron**	**197,542**	**36.4%**	**$ 3,205,253**	**$ 3,205,253**

Population figures per the Ohio Department of Development
Casino Tax figures per the Ohio Department of Taxation

Revenue Stability

While there are a multitude of variables in many of the revenue streams that fund county governments, revenue stability from the State of Ohio is needed moving forward to assist counties in managing their budgets and forecasting revenue trends into the future. Stabilizing as many of those major revenue sources as possible will assist counties both in budgeting operational expenses, but will also help those counties that may have major capital projects on the horizon, which will require debt financing.

For example, in Stark County, due to obsolete equipment that our vendor will no longer support, we need to upgrade/replace our public safety radio system, which supports our Sheriff in addition to many other police, fire and EMS agencies around our county. This project is estimated to be in excess of $12 million and will most likely require some level of project financing. For Stark County, the potential combination of a significant new debt payment (for the radio system), a substantial loss of Sales Tax revenue (Medicaid MCO tax exemption) and the potential reduction of additional State revenues as Ohio tries to cover its own Sales Tax revenue loss, would present a major budget challenge in the coming years.

Unlike the State and Federal Governments, County governments cannot create or change major revenue streams through Executive or Legislative action. Most of our primary sources of revenue are completely dependent upon either the economy or the State legislature. Regardless of those variables, the County must continue to operate and the people's work must be done.

With the impending Sales Tax revenue losses that we will all feel to some degree, I would request the Commission and our State Legislators look at all opportunities to help mitigate the revenue loss or replace the lost revenue to the Counties through other legislative means.

Conclusion

The Ohio 2020 Tax Policy Study Commission has no small task before it to meet its stated goals and I applaud each of you on the Commission for your willingness to do the heavy lifting.

The State of Ohio must not only have a tax code that is fair to those paying the taxes, but also fair to the Counties and other political subdivisions that depend on receiving a share of those taxes, to assist them in providing the many services that the residents and taxpayers of Ohio depend on every day.

Once again, I thank you for the opportunity to address the Commission today and I would be happy to answer any questions you may have.

Exhibit A

PERMISSIVE COUNTY AND TRANSIT AUTHORITY MHIC SALES TAX AS COMPARED TO TOTAL PERMISSIVE SALES TAXES DISTRIBUTED BY CALENDAR YEAR

MHICs are Medicaid Health Insuring Corporations, also known as Medicaid Managed Care Organizations

County	CY 2015 MHIC Sales Tax Distributed	CY 2015 Total Sales Tax Distributed	MHIC Total Ratio
Adams	$ 693,757	$ 4,106,838	16.9%
Allen	$ 907,048	$ 16,803,596	5.4%
Ashland	$ 382,673	$ 7,632,964	5.0%
Ashtabula	$ 1,117,688	$ 10,647,769	10.5%
Athens	$ 847,961	$ 8,334,593	10.2%
Auglaize	$ 366,618	$ 8,680,212	4.2%
Belmont	$ 1,026,323	$ 18,960,113	5.4%
Brown	$ 767,054	$ 5,248,844	14.6%
Butler	$ 3,051,238	$ 40,506,595	7.5%
Carroll	$ 220,081	$ 3,514,331	6.3%
Champaign	$ 457,990	$ 5,554,976	8.2%
Clark	$ 3,192,036	$ 24,960,364	12.8%
Clermont	$ 1,873,393	$ 26,101,453	7.2%
Clinton	$ 839,043	$ 8,471,449	9.9%
Columbiana	$ 2,136,967	$ 16,809,543	12.7%
Coshocton	$ 626,890	$ 5,814,125	10.8%
Crawford	$ 720,058	$ 5,815,620	12.4%
Cuyahoga	$ 21,020,069	$ 257,655,465	8.2%
Darke	$ 523,611	$ 8,578,007	6.1%
Defiance	$ 294,893	$ 5,672,831	5.2%
Delaware	$ 909,505	$ 51,735,541	1.8%
Erie	$ 606,022	$ 15,540,321	3.9%
Fairfield	$ 1,272,547	$ 20,400,299	6.2%
Fayette	$ 602,667	$ 8,294,487	7.3%
Franklin	$ 18,991,969	$ 285,941,787	6.6%
Fulton	$ 495,906	$ 7,744,991	6.4%
Gallia	$ 592,650	$ 4,953,354	12.0%
Geauga	$ 424,333	$ 14,051,414	3.0%
Greene	$ 1,331,450	$ 25,485,537	5.2%
Guernsey	$ 729,818	$ 10,016,453	7.3%
Hamilton	$ 12,712,740	$ 175,648,002	7.2%
Hancock	$ 473,305	$ 14,211,198	3.3%
Hardin	$ 392,310	$ 4,360,596	9.0%
Harrison	$ 247,354	$ 5,172,635	4.8%
Henry	$ 242,453	$ 3,923,645	6.2%
Highland	$ 807,226	$ 6,511,411	12.4%
Hocking	$ 497,129	$ 3,938,788	12.6%
Holmes	$ 140,452	$ 7,099,269	2.0%
Huron	$ 728,640	$ 9,986,008	7.3%
Jackson	$ 755,797	$ 5,512,664	13.7%
Jefferson	$ 1,323,181	$ 13,844,119	9.6%
Knox	$ 496,964	$ 6,947,056	7.2%
Lake	$ 1,597,887	$ 35,504,949	4.5%
Lawrence	$ 1,421,824	$ 8,965,402	15.9%
Licking	$ 2,073,818	$ 32,404,738	6.4%
Logan	$ 634,575	$ 9,208,842	6.9%
Lorain	$ 2,435,131	$ 28,825,845	8.4%
Lucas	$ 9,813,248	$ 94,573,924	10.4%
Madison	$ 515,110	$ 6,214,911	8.3%
Mahoning	$ 3,684,379	$ 38,754,809	9.5%
Marion	$ 1,237,290	$ 12,174,403	10.2%
Medina	$ 966,579	$ 24,452,389	4.0%
Meigs	$ 574,302	$ 2,647,626	21.7%
Mercer	$ 274,114	$ 7,580,017	3.6%
Miami	$ 851,077	$ 17,199,630	4.9%
Monroe	$ 234,719	$ 6,833,248	3.4%
Montgomery	$ 7,220,243	$ 78,599,097	9.2%

PERMISSIVE COUNTY AND TRANSIT AUTHORITY MHIC SALES TAX AS COMPARED TO TOTAL PERMISSIVE SALES TAXES DISTRIBUTED BY CALENDAR YEAR

MHICs are Medicaid Health Insuring Corporations, also known as Medicaid Managed Care Organizations

County	CY 2015 MHIC Sales Tax Distributed	CY 2015 Total Sales Tax Distributed	MHIC Total Ratio
Morgan	$ 287,433	$ 1,747,805	16.4%
Morrow	$ 486,982	$ 3,832,202	12.7%
Muskingum	$ 1,783,611	$ 19,135,842	9.3%
Noble	$ 168,566	$ 2,363,971	7.1%
Ottawa	$ 442,561	$ 8,358,460	5.3%
Paulding	$ 220,272	$ 1,935,518	11.4%
Perry	$ 707,482	$ 3,973,458	17.8%
Pickaway	$ 994,315	$ 8,121,058	12.2%
Pike	$ 760,127	$ 4,656,480	16.3%
Portage	$ 1,256,791	$ 20,645,675	6.1%
Preble	$ 552,574	$ 5,518,906	10.0%
Putnam	$ 194,921	$ 4,294,077	4.5%
Richland	$ 1,417,935	$ 22,691,496	6.2%
Ross	$ 1,553,973	$ 15,331,430	10.1%
Sandusky	$ 752,458	$ 11,249,746	6.7%
Scioto	$ 2,048,211	$ 12,107,485	16.9%
Seneca	$ 717,651	$ 8,572,925	8.4%
Shelby	$ 455,242	$ 9,938,871	4.6%
Stark	**$ 1,875,577**	**$ 28,772,692**	**6.5%**
Summit	$ 3,038,837	$ 44,373,867	6.8%
Trumbull	$ 2,738,395	$ 25,921,207	10.6%
Tuscarawas	$ 662,694	$ 12,951,881	5.1%
Union	$ 451,317	$ 13,507,799	3.3%
Van Wert	$ 292,458	$ 4,416,109	6.6%
Vinton	$ 352,210	$ 1,412,597	24.9%
Warren	$ 1,287,284	$ 36,463,895	3.5%
Washington	$ 858,999	$ 13,815,860	6.2%
Wayne	$ 805,642	$ 11,395,595	7.1%
Williams	$ 433,515	$ 5,801,145	7.5%
Wood	$ 857,382	$ 20,019,976	4.3%
Wyandot	$ 190,429	$ 3,914,359	4.9%
County Total	**$ 148,019,949**	**$ 1,982,371,478**	**7.5%**

Transit Authority	CY 2015 MHIC Sales Tax Distributed	CY 2015 Total Distributions	MHIC/Total
Greater Cleveland Regional Transit Authority	$ 16,816,055	$ 205,843,322	8.2%
Central Ohio Regional Transit Authority	$ 7,635,959	$ 125,439,291	6.1%
Laketran Transit Authority	$ 399,472	$ 8,832,168	4.5%
Western Reserve Transit Authority	$ 823,578	$ 8,580,592	9.6%
Greater Dayton Regional Transit Authority	$ 3,610,122	$ 39,246,288	9.2%
Portage Area Regional Transit Authority	$ 314,198	$ 5,156,388	6.1%
Stark Area Regional Transit Authority	**$ 937,788**	**$ 14,412,060**	**6.5%**
Metro Regional Transit Authority	$ 3,038,837	$ 44,190,357	6.9%
Transit Authority Total	**$ 33,576,009**	**$ 451,700,467**	**7.4%**
Grand Total	**$ 181,595,958**	**$ 2,434,071,945**	**7.5%**

Prepared by the Ohio Department of Taxation

MCOs is projected to be $195 million in SFY 2018 and $202 million in SFY 2019 (Tables 1 and 2).

Table 1. Ohio Sales Tax Revenue from Medicaid Managed Care Plans (SFY 2018)[4]

Medicaid MCP		State	Local	Federal
Medicaid MCPs pay 7% sales tax on $15.0 billion in services	$(1.055 billion) (7.05%)	$861 million (5.75%)	$195 million (1.3%)	$0
Medicaid MCPs are reimbursed 100% of the cost of the sales tax	$1.059 billion	$(303 million)	$0	$(756 million)
NET IMPACT	**$0**	**$558 million**	**$195 million**	**$(756 million)**

Table 2. Ohio Sales Tax Revenue from Medicaid Managed Care Plans (SFY 2019)[5]

Medicaid MCP		State	Local	Federal
Medicaid MCPs pay 7% sales tax on $15.6 billion in services	$(1.097 billion) (7.05%)	$895 billion (5.75%)	$202 million (1.3%)	$0
Medicaid MCPs are reimbursed 100% of the cost of the sales tax	$1.101 billion	$(317 million)	$0	$(784 million)
NET IMPACT	**$0**	**$578 million**	**$202 million**	**$(784 million)**

[4] Estimates developed by the Department of Medicaid using projected aggregate capitation payments and member months. Reimbursements for sales tax slightly exceed sales tax collections in a fiscal year because the collections are lagged by one month whereas reimbursements are made in the same month that services are provided.

[5] See above

Chairmen Peterson and Schaffer and members of the Ohio 2020 Tax Policy Study Commission

My name is Shane Wilkin and I am a Highland County Commissioner. I appreciate this opportunity to testify in front of you today regarding the loss of the Medicaid Managed Care sales tax dollars and specifically the effects of that loss on Highland County. Although I will be giving you examples that reflect Highland County, I believe that these negative effects will be reflective of other counties in my area.

First, allow me to share with you a brief history of Highland County's finances over recent years.

Highland County realized a peak general fund budget of $11.5 million dollars in 2008. The following year the budget was reduced to $10.8 million, a reduction of about 6 percent. This turned out to be not nearly enough of a reduction.

By February of 2009 Highland County had less the $8,000 cash on hand in the general revenue fund. Let me be clear, the available cash on hand in the General Revenue Fund was less than $8,000. As a result, the 2009 budget had to be further reduced, after 2 months of spending on a $10.8 million dollar pace, to approximately $9.8 million, an additional 9 percent reduction. These budget reductions involved furloughs and lay-offs in order simply to survive the year.

Calendar year 2010 brought more budget pain. The 2010 budget came in originally at just over $7.9 million. This is specifically where the Medicaid MCO sales tax dollars come into play. Highland County was told to anticipate approximately $350,000 in additional Medicaid MCO sales tax revenue. That brought us to a budget of $8.3 million for 2010 which represented a 28% general fund budget reduction from 2008. Obviously, these reductions included major budget restructuring as well as additional layoffs.

The original budget number of $7.9 million would have had to include the elimination of some departments. Highland County Soil and Water would have been "zeroed out" and Ohio State Extension was slated for possible elimination. Although this is a massive budget reduction, through the addition of Medicaid MCO sales tax monies of $350,000 we were able to save those programs from being eliminated. Knowing Chairman Peterson, I know he is aware of the value both of these departments provide to the county, even though not mandated by law.

Highland County still found itself in a poor financial condition after the budget reductions even with the inclusion of the Medicaid MCO sales tax dollars. I believe later that year is when I first met now Director Keen while he was with Auditor of State Mary Taylor and had to inform him that I could not afford to pay my audit bill as agreed and had to arrange a payment plan. I am happy to say that we fulfilled those terms and are now square. Thank you for your understanding and willingness to work with us at that time, Director Keen.

All of what I have mentioned now combined with the reduction of Local Government Funding and loss of tangible personal property tax revenues needless to say has magnified our financial issues. However, we did have the addition of the casino revenues which have helped the county. This revenue has come in at approximately 50% of the estimates originally given. I think it is fair to say that the racinos, whose dollars are not shared with the counties, have diminished the casino revenues.

I would also like to note the loss of investment or interest income that has affected us as well. Highland County has realized a loss of more than $500,000 per year. This revenue stream has not recovered from the Great Recession.

I would now like to bring you to 2015. Each of us in this room is acutely aware the opiate epidemic which is affecting not only my county, but the entire state of Ohio and our nation. The specific effect on Highland County has been an increase in our children in care from an average of 60 to over 100 in recent years with a peak at one point of 150. That is 150 children either temporarily or permanently placed in the county's care. It is not only a sad situation for the children affected, it has become a financial situation for the counties responsible for protecting our most innocent and valuable resource. Highland County residents, through a levy ($520,000) and an additional general fund expenditure of $980,000, will have spent a grand total of $1.5 million dollars in 2016. Ten percent of our current general fund is simply unsustainable.

The estimated loss of Medicaid MCO sales tax dollars for Highland County based on CY 2015 sales tax collections is $807,000. That represents just over eight percent of our current general revenue fund budget. Should our cost of children in care stay close to current levels, we would be looking at reducing our general revenue fund down to approximately $8.7 million, just $400,000 above our low during the "Great Recession."

Co-Chairs Peterson and Schaffer and members of the 2020 Tax Policy Commission, simply put, while sales tax dollars have no doubt seen an increase, they have been offset by reductions in other areas. Highland County is now in a situation where we live and die based on the monthly sales tax income. Of our 2016 GRF budget, sales tax represents 65 percent. When we look at a reduction in the Medicaid MCO sales tax, we look at a substantial reduction to our operating dollars.

Again, I appreciate your time and the opportunity to be here today and would gladly answer any questions to the best of my ability.

Streamlined Sales Tax Governing Board, Inc.

Testimony of Craig Johnson
Executive Director

Streamlined Sales Tax Governing Board

For the

Ohio Tax 2020 Study Commission

October 31, 2016

Co-Chairs Senator Peterson and Representative Schaffer and members of the Commission. I appreciate the opportunity to testify today.

My name is Craig Johnson and I am the Executive Director of the Streamlined Sales Tax Governing Board. I am here today to provide (1) a brief background on how the Streamlined Sales Tax project started; (2) our overall goals; (3) information on what our 24 member states (including Ohio) have done and are continuing to do to make it easier for both your in-state businesses as well as remote sellers making sales into Ohio to collect and remit your sales and use taxes; and (4) information and statistics to show the success of our organization and how it has helped states (including Ohio), businesses and consumers. I also want to talk with you about the need for a federal solution to resolve the remote seller sales tax collection issue and what members of the Ohio legislature may be able to do to help on this front.

Background on Creation of Streamlined

Streamlined was created in response to years of court battles ending with the United States Supreme Court's 1992 decision in *Quill v. North Dakota*. That decision basically said that a state cannot require a business without a physical presence in the state to collect and remit the states sales and use taxes because of the undue burdens that would be placed on those out-of-state retailers. However, the Court also said that "…Congress is now free to decide whether, when, and to what extent the States may burden interstate mail order concerns with a duty to collect use taxes…"

In the late 1990's, the National Governor's Association and the National Conference of State Legislatures decided it was time to sit down with the business community to identify what those undue sales tax administration burdens were and try to solve those issues. It was through this cooperative effort between the state legislators, state tax administrators, members of the business community, accountants and attorneys that the Streamlined Sales and Use Tax Agreement was originally developed and continues to operate today.

Streamlined's Goals and Efforts

The purpose of the Streamlined Sales Tax Governing Board is really very simple: to reduce unnecessary administrative burdens on the businesses that collect and remit sales tax. This includes both your in-state businesses as well as remote sellers making sales into Ohio. Streamlined does this by simplifying or making uniform administrative issues that businesses have indicated impose a burden on them when collecting sales tax. I want to make it very clear, however, that the Streamlined Sales Tax Governing Board does not decide what is taxable or exempt in any state. That decision is made by each state's legislature. In addition, nothing in the Streamlined Sales and Use Tax Agreement overrides your state's laws.

Our organization has the following goals:
(1) Make the sales tax collection and remittance administrative requirements as simple as possible;
(2) Where things cannot be made simpler, at least make them uniform;
(3) Balance the interest of state sovereignty with uniformity and simplicity;
(4) Help develop the best possible sales tax software and provide services to retailers that make sales tax calculation, return filing and making remittances as easy as possible; and

(5) Show Congress through practical experience that with the simplification and uniformity provisions enacted by our member states, the use of the certified service providers and advancements in technology, sales and use taxes can and are being easily and cost-effectively collected and remitted by sellers.

We continue to strive to eliminate the administrative differences between states while at the same time maintain each state's sovereignty by allowing them to choose what they will and will not tax. Some of the main areas that we have focused our simplification and uniformity efforts on include the following:

- State level administration of sales and use tax collections.
- Uniformity in the state and local tax bases.
- Uniformity of major tax base definitions.
- Central, electronic registration system for all member states.
- Simplification of state and local tax rates.
- Uniform sourcing rules for all taxable transactions.
- Simplified administration of exemptions.
- Simplified and uniform tax returns.
- Simplification of tax remittances.
- Protection of consumer privacy.

In addition to the above accomplishments, we continue to look at additional ways to remove or reduce administrative burdens for both in-state and remote sellers and work very closely with the business community in identifying additional areas where improvements can be made. Some of the issues we are currently working on include disclosed practices related to how states provide credits for taxes paid to other states, and how states treat transactions that occur after the original sale has been completed such as returns, refunds and exchanges and a uniform limited authorization form that will allow states to talk with the entity that prepared and filed their returns for them without having to execute a separate power-of-attorney in each instance.

Retailers have worked for a long time to automate every aspect of their business, including their sales tax collection and reporting obligations. Sales tax automation can be as simple as knowing what the sales tax rate is at any location or as complicated as knowing that a state has a 48 hour sales tax holiday on back-to-school supplies. The Streamlined states enhance the ability of retailers to automate their sales tax collection processes by adopting uniform sales tax rules, such as defining what products are included in a back-to-school sales tax holiday and by evaluating and then certifying the accuracy of the tax answers provided by our certified service providers (CSPs). The Streamlined certified service providers allow a retailer to automate and outsource their sales tax compliance obligations. In addition, the Streamlined states even pay the certified service companies to provide their tax calculation, return preparation, return filing and tax remittances services to retailers who do not have a physical presence in their state based on a percentage of the tax collected and remitted to the state. This greatly reduces and in many cases eliminates the undue burdens the United States Supreme Court discussed in the *Quill* decision.

Success of the Streamlined Sales Tax Governing Board
Many people do not realize or understand that all of the retailers that are currently registered and collecting the appropriate sales and use taxes in all 24 of our member states are doing so voluntarily. There is no state or federal mandate that requires these retailers to collect your tax if they don't have a physical presence in your state. However, because of the simplification and uniformity provisions contained in the Streamlined Sales and Use Tax Agreement and enacted by our member states, as of October 18, 2016, we have nearly 3,200 retailers voluntarily registered and collecting and remitting the taxes in all of our member states, regardless of any physical presence. While it is true that some of these retailers have a physical presence in one or more of our member states, few of them have a physical presence in all of the member states and therefore are voluntarily collecting and remitting these taxes for most of the member states.

Some of these retailers are using the certified service providers to handle their collection and remittance obligations, while others are handling it entirely on their own.

Since Streamlined became effective in October 2005, based on the amounts reported to me by our member states, these retailers have collected over $2.5 billion of sales and use taxes that were already legally due and owing and that otherwise may have gone uncollected. For Ohio, that amounts to about $40 million per year based on the reports I have received.

You also need to remember that the taxes these sellers are collecting are taxes that the purchasers are supposed to be paying directly to the state themselves if the sellers don't collect them. The unfortunate reality is that very few purchasers properly report this tax that is legally due and owing. However, by having the retailers collect this tax at the time of the sale it removes that recordkeeping burden from each individual purchaser, gets the revenue to the state and helps reduce the individual audits the states may otherwise need to conduct to collect these revenues. In the long run this saves the state and the purchaser time and resources.

It is also important to remember that if everyone pays the sales and use taxes that are already legally due and owing (not a penny more and not a penny less), this helps prevent states and local governmental units from having to either make cuts to some of the essential services citizens expect or to look at other methods of securing the necessary funding for these services.

E-Commerce's Continued Growth
E-commerce continues to gain a larger share of the retail market. In 2011, according to the U.S., Department of Commerce and Internet Retailer, e-commerce sales only represented about 6% of the total U.S. retail sales (excluding automobile, fuel and restaurant and bar sales). By 2015, it was over 10% and based on reports for 2016, that percentage is likely to increase to over 11%. According to the Department of Commerce, in the second quarter of 2016, e-commerce or web sales were 15.8% higher than they were in the 2nd quarter of 2015. I am not here at all to knock e-commerce or the growth of e-commerce, but instead want to make sure you understand what the impact is on Ohio with respect to this increase if these e-commerce sellers are not collecting and reporting the sales and use taxes. The impact of unpaid sales and use taxes isn't just a matter of Ohio not collecting what its tax law says should be collected. The sales tax is in many cases, the price difference that turns local retailers into show rooms for consumers who come in and try out a product and then go home and buy the product on-line. The likelihood of the sales tax

difference being a factor in a purchasing decision also increases as the price of the product being purchased increases.

The Need for a Federal Solution

The Streamlined Sales Tax Governing Board supports a federal solution to the remote sales tax collection issue. We also believe that the simplification and uniformity that our member states, including Ohio, have completed along with the significant advancements in technology since the *Quill* decision was issued back in 1992, may be more than enough to have the United States Supreme Court reconsider their decision in *Quill* and allow states to require remote sellers to collect and remit the appropriate sales and use taxes on their sales based on where the seller delivers the product to the purchaser.

The United States Senate introduced the Marketplace Fairness Act of 2013 and that bill passed the Senate on a bipartisan vote of 69-27. However, when it went over to the House of Representatives, the bill stalled in the Judiciary Committee. The Senate reintroduced the Marketplace Fairness Act of 2015 which was essentially the same bill that passed in 2013, with an amendment that would generally delay the effective date of the bill to the first day of the calendar quarter that is one year after the legislation is adopted. The Senate has not voted on that bill to date as it is waiting for the House to bring forth its product.

The Remote Transactions Parity Act of 2015 (HR2775) has been introduced in the United States House of Representatives by Congressman Jason Chaffetz and currently has 68 additional bipartisan co-sponsors (including 3 from Ohio – Reps. Stivers, Joyce and Renacci). However, the bill remains stalled in the House Judiciary Committee, primarily because the Committee Chairman does not support it.

The Remote Transactions Parity Act addresses several issues of concern raised after the Senate passage of the Marketplace Fairness Act in May 2013. Those issues include the small business exemption, audit procedures and exemptions, software costs and integration and certain liability relief provisions. The Governing Board is very supportive of Congressman Chaffetz's efforts and continues to provide technical guidance and input based on the experience and knowledge we has gained over the last 15+ years in developing the Streamlined Sales and Use Tax Agreement and is committed to helping find a federal solution that is fair to all parties involved – sellers, purchasers and the states.

House Judiciary Committee Chairman Bob Goodlatte released a discussion draft called the Online Sales Simplification Act (OSSA). It outlined his desire for an origin sourcing model and the use of a central clearing house. The bill has not been officially introduced to date. From the Governing Board perspective, we have strong concerns with this proposal. Our main concerns are that it (1) uses an origin-based sourcing regime, (2) takes away a state's sovereignty and (3) in many cases will result in new taxes (not taxes that are legally due and owing, but completely new taxes) being imposed.

<u>Origin Sourcing</u>

Origin sourcing (1) will lead to tax havens (which coincidentally will put upward pressure on other taxes to make up for the lost sales tax revenues), (2) will not solve the issue of an unlevel playing field among retailers, (3) will eventually put states and retailers right back in the same position they are in today and (4) may be unconstitutional under either or both the Equal Protection clause and the Due Process clause.

State Sovereignty

The OSSA proposal steps on state sovereignty in several ways. It (1) preempts a state from imposing its tax based on its current nexus laws that follow destination sourcing, (2) prohibits audits of remote sellers by the state to which the tax is ultimately due and owing and (3) forces states to select a single state-wide sales tax rate to apply to remote sales.

Imposition of New Taxes – Not Just Collecting Taxes That Are Currently Legally Due and Owing

The OSSA, as drafted will also result in the imposition of new taxes that are not currently legally due and owing. This will happen for at least two different reasons. First, many state legislatures have chosen to exempt certain products from their state's tax base. One example is clothing. Under the OSSA, all purchases of clothing from remote sellers will be subject to tax if the remote seller is located in a state that does not exempt clothing. Many of these purchasers are not currently required to pay this tax.

Secondly, the OSSA will result in the imposition of new taxes that are not currently legally due and owing if every state is required to impose the tax using "one rate per state." Most states have various local taxes that are imposed in addition to their state's general statewide rate. However, the states generally allow their local units of government to set their own rates within certain parameters. This results in a number of different rates being imposed throughout the state. If a state computes the weighted-average of its local rates and adds that to its general statewide rate as the OSSA contemplates, this will result in a new tax/tax increase for any purchasers that are living in a taxing jurisdiction with a rate that is currently less than the state rate plus the weighted average of the local rate.

How You Can Help

Getting a federal solution to the remote sales tax collection problem will help every state collect the sales and use taxes that are already legally due and owing, will level the playing field for all your in-state businesses and help eliminate the need for individual consumers to track and report the taxes they owe on purchases from remote sellers.

As members of the Ohio Legislature, I would strongly encourage you to reach out to your Congressional members and their staffs and encourage them to support the Marketplace Fairness Act or the Remote Transactions Parity Act. Explaining to them and educating them about your state's direct interest and how the growth of e-commerce and sellers not being required to collect your state's sales and use taxes harms your state is critical and they need to know they have support from you.

Conclusion

The Streamlined Sales Tax Governing Board will continue to find ways to make the collection and remittance of sales and use taxes as simple and uniform as possible and at the same time recognizing each state's sovereignty. As stated previously, our ultimate goal is to have Congress enact a federal solution to the remote sales tax collection issue that is fair to the states, the business community and consumers.

Thank you again for the opportunity to speak with you today and I would be glad to try to answer any questions you may have for me.

National Conference *of* State Legislatures

The Forum for America's Ideas

Testimony Of

Max Behlke
Manager of State-Federal Relations
National Conference of State Legislatures

On

Remote Sales Tax Collection

Before The

Ohio 2020 Tax Policy Study Commission

October 31, 2016

Attachment 1: State Activity Regarding Remote Sales Tax Collection in 2016
Attachment 2: NCSL Policy Regarding Remote Sales Tax Collection
Attachment 3: NCSL Letter to Legislative Leaders from January 20, 2016
Attachment 4: Model Legislative Proposal Sent to State Leaders on January 20, 2016

Co-Chairs Senator Peterson and Representative Schaffer and Members of the Commission,

My name is Max Behlke and I am the Manager of State-Federal Relations in the Washington D.C. Office of the National Conference of State Legislatures. I am here today to provide an overview of the remote sales tax collection issue at both the state and federal levels.

As you know, NCSL is the bipartisan national organization that represents every state legislator from all fifty states and our nation's commonwealths, territories, possessions and the District of Columbia. NCSL is the voice of state legislatures in our federal system as we advocate on behalf of the states' agenda: supporting state sovereignty and state flexibility and protecting against unfunded federal mandates and unwarranted federal preemption.

Remote Sales Tax Collection: A Problem for States

The Supreme Court of the United States ruled in the 1992 case of *Quill v. North Dakota* that consumers owe applicable sales taxes on purchases made from out-of-state businesses but also ruled that states cannot require those businesses to collect and remit those taxes. The court reasoned that it was too complicated for sellers to comply with the various sales tax systems of every state where they made sales. In the opinion, the court also urged Congress to pass legislation to fix the problem as the it was the more appropriate branch of government to do so. However, in the twenty-four years since, Congress has yet to act even though the problem has only gotten worse - principally because of the advent and growth of electronic commerce.

In 1992, very few people even had personal computers, let alone bought anything online. Now, e-commerce is booming. This past Black Friday for instance, for the first time ever, more people shopped online than did in stores. For the last five years, e-commerce grew by 15% each year and now accounts for 7%[1] of all retail sales. And while many people shop online for convenience, many do so because they did not have to pay taxes (even though they are required to voluntarily remit them). Often, shoppers go to stores to browse products in person and then buy them online to save the 5-10% in taxes. Moreover, online shoppers often choose to shop from retailers that do not collect sales tax over retailers that do. A 2016 study by The Ohio State University found that Amazon's sales decreased by 10% in states where it collected sales tax, compared to states where it did not.[2] So, not only are the states losing billions of dollars each year in owed revenue, brick and mortar stores and online retailers that are collecting and remitting applicable tax are competing on an unlevel playing field.

[1] http://www.census.gov/retail/index.html#ecommerce

[2] Brian Baugh, Itzhak Ben-David, and Hoonsuk Park, "Can Taxes Shape an Industry? Evidence from the Implementation of the "Amazon Tax", Fisher College of Business, The Ohio State University, September 2016.

Ohio Sources of Revenue

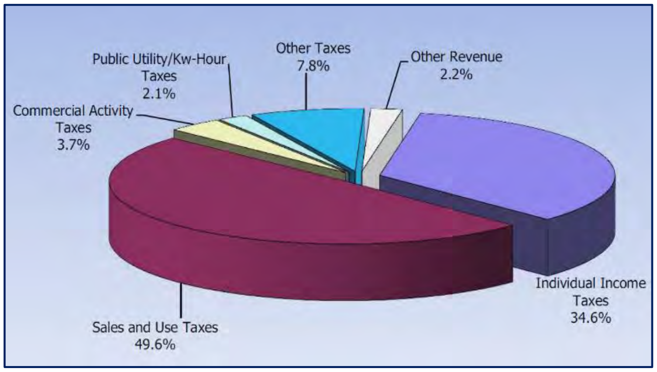

Figure 1: Source: State of Ohio Revenue Summaries

Average of the 50 State Revenue Sources

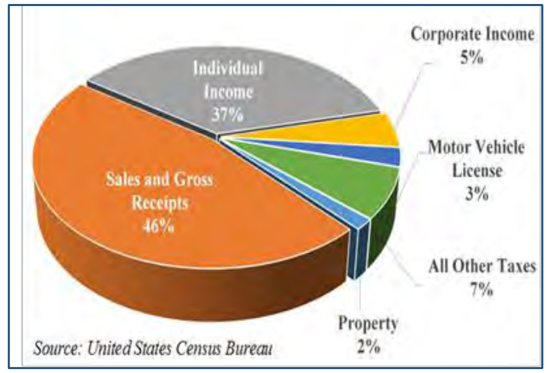

Figure 2

States are heavily reliant on sales and exise taxes, accounting for nearly half of state raised revenue. Sales taxes alone account for 34% of state revenue. In Ohio, nearly half of all state revenue is from sales and use taxes. Therefore, the inability to collect these taxes threatens long term viability of the tax.

A study by the University of Tennessee estimated that states lost approximately $23 billion[3] in 2012 due to the inability to collect taxes on out-of-state purchases. While the study has not been updated with more recent estimates, it nonetheless underscores the inability to collect taxes can lead to significant revenue losses. In Ohio alone, the study estimated that the state forgoes over $300 million[4] annually in owed taxes, $180 million of which is due to internet sales.

Federal Legislation

In 2013, the United States Senate overwhelmingly passed the Marketplace Fairness Act, which would have closed the tax loophole by providing states that complied with certain simplification requirements the authority to collect the taxes they are owed. But it has languished for more than 3 years in the House Judiciary Committee without receiving a hearing. The committee has also failed to consider a more substantive legislative proposal introduced by U.S. Representative Jason Chaffetz (R) of Utah, the Remote Transactions Parity Act, which would also provide states collection authority if they met certain requirements.

There are currently three remote sales tax legislative proposals being considered before Congress:

- Marketplace Fairness Act of 2015 (NCSL Supports)
- Remote Transactions Parity Act (NCSL Supports)
- Online Sales Simplification Act (in draft form only; NCSL Opposes)

[3] http://www.ncsl.org/research/telecommunications-and-information-technology/2012-uncollected-use-tax.aspx
[4] Id.

The **Marketplace Fairness Act (MFA)** and the **Remote Transactions Parity Act (RTPA)** are similar and both apply a product's taxability and tax rate based on the location of the customer, which is known as "destination souring." Both proposals also grant collection authority to states that are full members of the Streamlined Sales and Use Tax Agreement (SST states) and to non-SST states which enact state legislation to adopt the simplification provisions and implement all of the requisites detailed in each bill. MFA and RTPA would require states that choose to participate to have:

- A single state-level entity to administer all sales and use tax laws;
- A single audit for all state and local taxing jurisdictions within the state;
- A single sales and use tax return for remote sellers to file with the state-level entity;
- A uniform sales and use tax base among the state and its local taxing jurisdictions;
- Information regarding the taxability of products and services, along with any product and service exemptions.
- A rates and boundary database; and
- A 90-day notice of rate changes, along with liability relief to both remote sellers and Certified Service Providers (CSPs).

Moreover, neither proposal would preempt or impose requirements on states that chose not to participate.

As one of the full member states of Streamlined Sales and Use Tax Agreement, Ohio has already enacted the requisite legislative simplifications of MFA to require all sellers not meeting the small business exemption to begin collecting remote sales and use taxes within 180 days of the enactment of the bill. This is also true for most all of the requirements in RTPA, however, the state may have to enact clarifying legislation or issue certain regulatory changes under the act's requirements. In both federal proposals, SSUTA compliant states' revenue departments would be required to issue a notice the state intends to require sales tax collection by out of state sellers in 180 days.

The **Online Sales Simplification Act (OSSA)** is radically different than both MFA and RTPA. While it has yet to be introduced, its draft framework would base a product's taxability on the location of the retailer and would require states to have a single rate for all remote sales. This is problematic in that it would 1) preempt a state's sovereignty to determine whether or not to impose taxes on out-of-state purchases, 2) would raise taxes on consumers; and 3) would add confusion and complexity for sales tax collection both for the taxpayer and state.

The proposal would also preempt laws in nearly every state that imposes sales tax, regardless of whether or not they chose to participate in the system that the proposal establishes.

As Congress prepares for the upcoming Lame Duck session that will follow the election, it appears unlikely that lawmakers will have the time to address the issue this year, unless a legislative proposal is included as part of the end of year spending package. If Congress does not take action this year, it is unlikely that it will address the issue in the early part of the next Congress, which may be even more gridlocked than it is now.

State Activity

For over two decades, states have worked to find a solution to address on the remote sales tax collection problem. The **Streamlined Sales and Use Tax Agreement** was created by the National Governors Association and the National Conference of State Legislatures in the fall of 1999 to simplify sales tax collection in order to overcome the complexities highlighted in *Quill*. The Agreement minimizes costs and administrative burdens on retailers that collect sales tax, particularly retailers operating in multiple states. Legislation was then introduced that asked Congress to grant states that conform to the Agreement remote sales tax collection authority. And even though over half of the states the levy sales taxes have joined Streamlined, Congress never took action that would grant Streamlined states collection authority.

As Congress continued to stall and seemed increasingly unlikely to grant collection authority to Streamlined states, states began to look for other ways that they could solve the issue. These efforts began in 2008, when New York enacted the first **affiliate nexus tax/affiliate tax law,** which required retailers that have contracts with "affiliates" -- independent persons within the state who post a link to an out-of-state business on their website and get a share of revenues from the out-of-state business -- to collect the state' sales and use tax. The approach presumes that certain individuals and organizations in the state that have a specified relationship with the out-of-state vendor are affiliates of the vendor that constitutes the requisite physical presence in the state to allow the state to require the vendor to collect sales tax. And even though dozens of states enacted a form of this legislation, few of them realized or will realize an appreciable increase in tax collections. This is because online retailers canceled their in-state affiliate arrangements and because the laws only potentially reach remote vendors with affiliate arrangements. That being said, there is little doubt about the constitutionality of these laws as the United States Supreme Court declined hearing a case that challenged the validity of the New York law.

DMA v. Brohl: Reporting and Notification Requirements

In 2010, the state of Colorado enacted legislation that imposed notification and reporting requirements on out-of-state retailers that do not collect sales tax in the state. The Colorado law requires out-of-state retailers to 1) notify Colorado purchasers letting them know that they may be subject to Colorado's use tax, 2) send an "annual purchase summary" to Colorado purchasers who buy more than $500 in goods from the retailer with the dates, categories, and amounts of purchases; and 3) file an annual "customer information report" with the Colorado Department of Revenue listing their customers' names, addresses, and total amounts spent.

The Direct Marketing Association challenged the constitutionality of the law in federal court. The case was ultimately appealed to the United States Supreme Court regarding the applicability of the Tax Injunction Act[5] (TIA), which is a federal law that guides court jurisdiction of state tax cases, rather than on the constitutionality of the reporting requirements themselves. The court ultimately found for the petitioners, which allowed for the 10th Circuit to then consider the constitutionality of the reporting requirements. Moreover, in a concurring opinion, Kennedy requested that the legal system "find an appropriate case for [the] Court to reexamine" the long-standing *Quill* precedent, a remnant of bygone days that fails to take into account "the dramatic technological and social changes that [have] taken place in our increasingly interconnected economy" since that decision was handed down in 1992.[6]

On February 22, 2016, the United States Court of Appeals for the Tenth Circuit upheld the constitutionality of the Colorado law. The court held that the notification and reporting requirements do not violate the Commerce Clause because they do not discriminate against or unduly burden interstate commerce. The case has been appealed and the United States Supreme Court is currently reviewing the case to determine whether or not to grant the appeal. (Note: The State and Local Legal Center, on behalf of the organizations that represent the nation's state and local governments, including NCSL, filed an amicus brief on October 24, 2016 urging the court to deny the appeal.)

State Action in 2016

Frustrated by Congress, especially the House Judiciary Committee, and empowered by Justice Kennedy's concurring opinion in *DMA v. Brohl*, many state legislators, including those on NCSL's

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[5] Tax Injunction Act: provides that federal district courts "shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State.

[6] *Direct Marketing Association v. Brohl.*

Executive Committee and NCSL's Task Force on State and Local Taxation, which I staff, believed that it was time to act in their own legislative chambers given Congressional inaction.

Therefore, on January 20th of this year, NCSL sent a letter to the legislative leaders of the 45 sales tax states (attached) along with a legislative proposal (attached) providing options to states that wished to address this issue in their states this year. In the 2016 legislative sessions, 20 states introduced 43 legislative measures, 4 of which were enacted, that were aimed at requiring out-of-state companies to collect taxes on Internet sales and remit them to the states.

Broadly, the state efforts included:

- Enacting legislation with the intent of reversing the Supreme Court's 1992 *Quill* decision.
- Expanding the types of businesses that states can require to collect and remit taxes.
- Expanding collection requirements to marketplace providers.
- Expanding state reporting and registration requirements.

South Dakota's Legislation

Of the enacted laws, South Dakota's legislation, Senate Bill 106, is most notable. The legislation is straightforward as it requires businesses that sell more than $100,000 in goods or processed 200 or more transactions a year in South Dakota to collect and remit the state's sales taxes.

The legislation was clearly written to force a legal challenge and aimed to ultimately overturn the U.S. Supreme Court's 1992 *Quill vs. North Dakota* decision as it included what is tantamount to a legal brief into Section 8 of the bill. The section discusses a number of legislative findings, including the following:

"As Justice Kennedy recently recognized in his concurrence to Direct Marketing Association v. Brohl, the Supreme Court of the United States should reconsider its doctrine that prevents states from requiring remote sellers to collect sales tax..."

In addition, S.B. 106 creates procedures designed to expedite a legal challenge to its provisions. The law states that if its legality is challenged, the case must be heard "as expeditiously as possible" by a state Circuit Court. Appeals would then go directly to the South Dakota Supreme Court (South Dakota does not have a court between the State Circuit Court and the State Supreme Court), which must also hear the case expeditiously.

Before the law became effective, the state sent letters to just over 200 online retailers to let them know they'd either need to start paying sales tax or risk legal action. At that point, 70 remote sellers applied for a sales tax license and started collecting the state's sales tax.

Following the procedures specified in S.B. 106, the state filed a complaint in state court alleging that certain online retailers met the criteria in Senate Bill 106 and sought a declaratory judgment that the new law was constitutional and that the defendant retailers should be required to collect and remit tax on sales into the state.

Per the legislation, the filing of a declaratory action operated as an injunction against the state enforcing the collection obligation (unless the seller consents to collect or voluntarily remits) during the pendency of the action.

The defendants, the out-of-state sellers required to collect sales and use tax under Senate Bill 106, quickly removed the case to federal district court. On July 22, 2016, the state filed a motion seeking to have the case remanded to the Hughes County, South Dakota State Circuit Court. The state's motion argues that, based on two Supreme Court cases, this case should be heard in state court.

First, South Dakota argues that federal courts lack jurisdiction in declaratory judgment cases when a state seeks a declaration that its own law is consistent with federal requirements. The state is also asserting that state tax cases such as this one belong in state courts as a matter of federal-state comity. On the same day, July 22, the defendants filed a motion and supporting brief in federal district court to have the matter resolved by summary judgment. At the end of August, briefing on the question of whether the matter should be remanded to the state court or decided on summary judgment in the federal district court was completed.

If the case is remanded back to the state circuit court, it could be move quickly through the state court system, which would allow for the parties to petition for certiorari before the United States Supreme Court.

Alabama's Regulation

Alabama began enforcing a regulation on January 1st of this year that requires that any seller, regardless of its physical connection with the state, to collect and remit sales taxes if it is determined to have "economic presence" in the state.

Economic presence is generated when both of the following criteria are met:

1. sales of tangible personal property into the state exceed $250,000 per year; and,

2. the seller conducts one or more of the additional activities listed in Alabama Code Section 40-23-68. Examples of these additional activities include:
   - the seller is qualified to do business with the state;
   - the retailer solicits orders of tangible personal property from Alabama customers by using a broadcaster or publisher located within the state;
   - the company has recurring sales to Alabama residents that are solicited by mail; or,
   - the seller distributes catalogs to residents of Alabama.

The rule was intended to challenge *Quill*.

Newegg filed suit against the state on June 8, 2016 challenging the rule's constitutionality. The lawsuit was filed in the Alabama Tax Tribunal, which is unlike the South Dakota lawsuit that was filed in state court.

Frank Miles, a spokesman for the Alabama Department of Revenue, said the Department forecasts that the rule will generate $40 million to $50 million in fiscal 2017.

<u>Conclusion</u>

NCSL is committed to finding a solution to the remote sales tax collection issue and will continue to advocate on behalf of states in Washington and will assist states with any legislative efforts at the state level. Thank you and I look forward to your questions.

Attachment 1

State Activity Regarding Collection of Legally Owed Sales Tax on Remote Sales

This attachment summarizes notable recent state activity regarding collection of legally owed sales tax on remote sales. It does not cover earlier state legislative measures in this area, such as affiliate nexus; rather, it outlines the state activity that has already led to legal challenges–in Alabama, Colorado, and Tennessee—that could result in the U.S. Supreme Court reconsidering its *Quill* decision.

Alabama

Law: Rule 810-6-2-.90.03 - Effective January 1, 2016

Summary: Establishes that any seller, regardless of its physical connection with the state, is required to collect and remit sales taxes if it is determined to have "economic presence" in the state.

Economic presence is generated when both of the following criteria are met:

3. sales of tangible personal property into the state exceed $250,000 per year; and,
4. the seller conducts one or more of the additional activities listed in Alabama Code Section 40-23-68. Examples of these additional activities include:
   - the seller is qualified to do business with the state;
   - the retailer solicits orders of tangible personal property from Alabama customers by using a broadcaster or publisher located within the state;
   - the company has recurring sales to Alabama residents that are solicited by mail; or,
   - the seller distributes catalogs to residents of Alabama.

The rule was intended to contradict *Quill*.

Lawsuit: Newegg filed suit against the state on June 8, 2016 challenging the rule's constitutionality. The lawsuit was filed in the Alabama Tax Tribunal, which is unlike the South Dakota lawsuit that was filed in state court.

Frank Miles, a spokesman for the Alabama Department of Revenue, said the Department forecasts that the rule will generate $40 million to $50 million in fiscal 2017.

Arizona

Law: A.R.S. § 42-5061 - Signed September 20, 2016

Summary: Rule for Online Marketplaces. A business that operates an online marketplace and makes online sales on behalf of thirdparty merchants as evidenced by the marketplace providing a primary contact point for customer service, processing payments on behalf of the merchant and providing or controlling the fulfillment process, is a retailer conducting taxable sales. The gross receipts of that marketplace business derived from the sales of tangible personal property to Arizona purchasers are subject to retail TPT, provided that the business already has nexus for Arizona TPT purposes.

Colorado

Law: House Bill 10-1193 - Enacted February 24, 2010. Effective March 1, 2010.

Summary: The bill was intended to increase the collection of state sales and use taxes by offering out-of-state retailers selling goods to Coloradans the choice of either:

1. Voluntarily collecting sales taxes from its Colorado customers; or
2. These retailers must inform purchasers at the time of the sale that a use tax may be due and that Colorado requires them to file sales and use tax returns and pay use taxes directly to the state.

   By Jan. 31 of each year, these retailers must provide each Colorado purchaser with a reminder of the use tax and provide the dates, amounts and categories of each purchase, if available.

   These retailers must file annual reports with the Colorado Department of Revenue by March 1 that includes, on a purchaser-by-purchaser basis, the total amount paid for Colorado purchases in the prior year

Lawsuit: The Direct Marketing Association (DMA) filed a suit against the state on June 30, 2010.

The lawsuit claimed that the law violated:

- The Interstate Commerce Clause of the U.S. Constitution by forcing out-of-state retailers to incur compliance costs that Colorado retailers will not incur;
- Colorado consumers' constitutional rights to privacy;
- Both out-of-state retailers' and Colorado consumers' rights to free speech; and
- Out-of-state retailers' right to not be deprived of property without due process of law by requiring the retailers to provide consumer information to the DOR. The DMA alleges that the DOR has a track record of failing to adequately protect the privacy of this kind of information.

The Direct Marketing Association (DMA) sued the State in federal District Court and sought a permanent injunction on the grounds that the Colorado law was unconstitutional as it violated the Commerce Clause. The federal District Court ruled in favor of DMA. The State appealed to the 10th Circuit Court of Appeals, which did not reach a decision on the merits of the appeal, rather, held that the Tax Injunction Act (TIA)[7] deprived the federal district court of jurisdiction to enjoin Colorado's tax collection effort and then reversed the lower court's decision for lack of jurisdiction. DMA appealed the decision to the U.S. Supreme Court, which granted certiorari on July 1, 2014.

At this time, the State and Local Legal Center (SLLC) filed an amicus brief with the Supreme Court in the case of *DMA v. Brohl*. While the SLLC brief did not take a position on the TIA, it did make a strong case that the *Quill* decision has negatively impacted state sales tax revenues and how the now-antiquated decision's negative effects were exacerbated by the rapid growth of Internet commerce. The brief also discussed the efforts by states to meet the concerns raised by the Court in its *Quill* decision, chiefly the creation of the Streamlined Sales and Use Tax Agreement.

[7] The Tax Injunction Act (TIA)- Federal district courts shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State.

On March 3, 2015 the Supreme Court issued a unanimous decision in favor of DMA and sent the case back to the 10th Circuit for further consideration on the merits. However, in a concurring opinion, Justice Kennedy called into question the Court's 23-year-old holding in *Quill Corp v. North Dakota*. His statement, which drew directly from the SLLC brief, called upon the states to send an "appropriate case" to the Court so that the Court could revisit its decision in *Quill*.

On February 22, 2016, a three judge panel of the U.S. Court of Appeals for the 10th Circuit ruled unanimously for Colorado and found that the law was constitutional and did not cause undue harm on out-of-state sellers. DMA subsequently petitioned the 10th Circuit Court for a rehearing *en banc*, but that petition was denied. The DMA then filed a petition of *cetiorari* to the United States Supreme Court on September 1, 2016.

It is our understanding that Colorado will file a "Conditional Cross Petition" on October 3, 2016. A Conditional Cross Petition is a petition that asks the Court to not grant certiorari in a case, but if the Court decides to grant certiorari, it should also grant the conditional cross-petition so that the Court can fully consider the underlying question in the case. In the DMA case, the Colorado petition will ask the Court to not to take up the DMA appeal, but will state that if the Court does, it should also review the *Quill* decision. The Colorado petition will make the case for overturning *Quill*.

Louisiana

Law: House Bill 1121: Enacted June 17, 2016. Effective July 1, 2017.

Summary: Establishes use tax notification requirements for remote retailers that are not collecting the state's sales tax and who have annual Louisiana sales in excess of $50,000. The sellers must notify Louisiana purchasers of their use tax obligation, send an annual notification to purchasers showing the total amount paid in the preceding calendar year, and file an annual statement with the secretary of the Department of Revenue.

Ohio

Law: Commercial Activity Tax (CAT) on Remote Sales

On May 3, 2016, the Supreme Court of Ohio heard oral argument between Crutchfield Corporation—a major electronics retailer based in Virginia—and Ohio Tax Commissioner Joseph Testa regarding whether Ohio can tax an out-of-state company based on sales of goods to Ohio consumers over the internet.

The case arose when the Ohio Department of Taxation issued 27 tax assessments totaling more than $209,000 for Crutchfield relating to periods from 2005 to 2012. The basis for the tax assessment is the Ohio Commercial Activity Tax ("CAT"), which imposes a bright-line jurisdictional reach on businesses: As long as a company has $500,000 or more in annual sales from Ohio customers, as measured by gross receipts, then the company is liable for CAT. Because CAT imposes a tax on out-of-state businesses, it must satisfy the "substantial nexus" test created by the U.S. Supreme Court in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), and its progeny.

South Dakota

Law: Senate Bill 106 – enacted on March 22, 2016. Effective date: May 1, 2016.

Summary: Legislation requires businesses that sold more than $100,000 in goods or processed 200 or more transactions a year to collect and remit the state's sales taxes.

The legislation was clearly written to force a legal challenge and aimed to ultimately overturn the U.S. Supreme Court's 1992 *Quill vs. North Dakota* decision. Section 8 of the bill enacts a number of legislative findings, including the following:

> "As Justice Kennedy recently recognized in his concurrence to *Direct Marketing Association v. Brohl*, the Supreme Court of the United States should reconsider its doctrine that prevents states from requiring remote sellers to collect sales tax..."

In addition, S.B. 106 creates procedures designed to expedite a legal challenge to its provisions. The law states that if its legality is challenged, the case must be heard "as expeditiously as possible" by a state Circuit Court. Appeals would then go directly to the South Dakota Supreme Court (South Dakota does not have a court between the State Circuit Court and the State Supreme Court), which must also hear the case expeditiously.

Before the law became effective, the state sent letters to just over 200 online retailers to let them know they'd either need to start paying sales tax or risk legal action. At that point, 70 remote sellers applied for a sales tax license and started collecting the state's sales tax.

Lawsuits:

1) The State issued a declaratory judgment action and filed a suit against the internet retailers Wayfair, Systemax, Overstock.com, and Newegg on April 28, 2016.
2) Netchoice & the American Catalog Mailers Association (ACMA) filed a suit on April 29, 2016.

Following the procedures specified in S.B. 106, the state filed a complaint in state court alleging that certain online retailers met the criteria in Senate Bill 106 and sought a declaratory judgment that the new law was constitutional and that the defendant retailers should be required to collect and remit tax on sales into the state.

Per Senate Bill 106, the filing of a declaratory action operated as an injunction against the state enforcing the collection obligation (unless the seller consents to collect or voluntarily remits) during the pendency of the action.

The defendants, the out-of-state sellers required to collect sales and use tax under Senate Bill 106, quickly removed the case to federal district court. On July 22, 2016, the state filed a motion seeking to have the case remanded to the Hughes County, South Dakota State Circuit Court. The state's motion argues that, based on two Supreme Court cases, this case should be heard in state court.

First, South Dakota argues that federal courts lack jurisdiction in declaratory judgment cases when a state seeks a declaration that its own law is consistent with federal requirements. The state is also asserting that state tax cases such as this one belong in state courts as a matter of federal-state comity. On the same day, July 22, the defendants filed a motion and supporting brief in federal district court to have the matter resolved by summary judgment. At the end of August, briefing on the question of whether the matter should be remanded to the state court or decided on summary judgment in the federal district court was completed.

If the case is remanded back to the state circuit court, it could be move quickly through the state court system, which would allow for the parties to petition for *certiorari* before the United States Supreme Court.

Tennessee

Law: Proposed Rule 1320-05-01-.129 on August 8, 2016. Effective 90 days after being published, which is expected to occur shortly.

Summary: The Tennessee Department of Revenue held a public hearing on Proposed Rule 1320-05-01-.129 on August 8, 2016. The proposed rule requires an out-of-state seller who engages in the regular or systematic solicitation of consumers in the state through any means, and whose Tennessee taxable sales exceed $500,000 during any calendar year, has substantial nexus in the state.

An out-of-state seller subject to the economic nexus standard must register with the Department for sales and use tax purposes by January 1, 2017, and report and pay tax on sales of tangible personal property and other taxable items delivered to Tennessee consumers by July 1, 2017.

The economic nexus rule is not yet final. However, now that a public hearing has been held, the Department is expected to issue a final rule after various internal reviews are completed. Once the final rule is filed with the Secretary of State, it will become final 90 days after the date of such filing.

Utah

Law: Currently being drafted. Expected to be prefiled in October.

Summary: Economic Nexus (South Dakota). Utah Sen. Curtis Bramble (R) said lawmakers in his state are in the final stages of drafting a bill that's similar to the South Dakota bill. He cited uncertainty over whether Congress will act on the issue as the reason Utah wants to join the ranks of states fighting to overturn the U.S. Supreme Court's 1992 decision in *Quill*.

Vermont

Law: H.B. 873: Enacted May 25, 2016. Effective July 1, 2017 or the first quarter after the Colorado begins enforcing their law currently being challenged in *DMA v. Brohl*.

Summary: The legislation implements a Colorado-style use tax notification system. Requires sellers which either regularly solicit sales or which made $100,000 worth of sales (or 200 individual sales transactions) within the state in the previous 12 months to comply.

Wyoming

Law: Currently being drafted. Expected to be discussed at the next Joint Interim Revenue Committee meeting in November 2016.

Summary: Economic Nexus (South Dakota). Wyoming Department of Revenue Director Dan Noble said one of the state's legislative committees has drafted a bill that is nearly identical to South Dakota's SB 106. Noble said the bill is advancing but is still in the discussion stages.

Attachment 2

NATIONAL CONFERENCE *of* STATE LEGISLATURES

The Forum for America's Ideas

NCSL SUPPORTS AND URGES ENACTMENT OF THE REMOTE TRANSACTIONS PARITY ACT

WHEREAS, the 1967 Bellas Hess and the 1992 Quill Supreme Court decisions denied states the authority to require the collection of sales and use taxes by out-of-state sellers that have no physical presence in the taxing state; and

WHEREAS, the combined weight of the inability to collect sales and use taxes due on remote sales through traditional carriers and the tax erosion from electronic commerce threatens the future viability of the sales tax as a stable revenue source for state and local governments; and

WHEREAS, a report from the National Taxpayers Union has estimated that from 2015 to 2025 states will be unable to collect $340 billion in sales taxes that are owed from out-of-state purchases; and

WHEREAS, the Remote Transactions Parity Act is bi-partisan legislation that was introduced in the United States House of Representatives which authorizes each member state under the Streamlined Sales and Use Tax Agreement to require all sellers not qualifying for a small-seller exception to collect and remit sales and use taxes with respect to remote sales, and allows a state that is not a member state under the Agreement to require sellers to collect and remit sales and use taxes with respect to remote sales sourced to such state if the state adopts and implements certain minimum simplification requirements; and

WHEREAS, unlike federal proposals, such as the Online Sales Simplification Act (OSSA), which would determine a product's taxability based on the location of the seller, the Remote Transactions Parity Act does not preempt or impose new requirements on states that choose not to comply with the legislation's requirements and simplifications; and

WHEREAS, unlike federal proposals, such as the Online Sales Simplification Act (OSSA), which would determine a product's taxability based on the location of the seller, the Remote Transactions Parity Act does not: impose new taxes on consumers, fundamentally change how states raise revenue, establish tax havens, or jeopardize the viability of consumption taxes as a revenue source for states; and

WHEREAS, it has been over three years since the United States Senate overwhelming passed similar legislation, the Marketplace Fairness Act, yet the Remote Transactions Parity Act has not even received a hearing, despite the fact that it has 65 cosponsors and enjoys broad support in the committee of jurisdiction and congress; and

NOW, THEREFORE BE IT RESOLVED THAT, the National Conference of State Legislatures (NCSL) appreciates the leadership of U. S. Senators Richard Durbin (Ill.), Mike Enzi (Wyo.), Lamar Alexander (Tenn.) and Heidi Heitkamp (N.D.) for championing this issue in the Senate; and

BE IT FURTHER RESOLVED THAT, the National Conference of State Legislatures appreciates the leadership of Congressman Chaffetz and his colleagues in drafting the Remote Transactions Parity Act and urges Congress to pass the legislation, co-sponsored in the House by Congressman Steve Womack (Ark.), Congressman John Conyers (Mich.), Congresswoman Kristi Noem (S.D.), Congresswoman Jackie Speier (CA.), Congressman Peter Welch (Vt.), and dozens of their colleagues; and

BE IT FURTHER RESOLVED THAT, the National Conference of State Legislatures opposes federal remote sales tax legislation that preempts the laws of states that choose to not comply with the legislation's requirements; and

BE IT FURTHER RESOLVED THAT, the National Conference of State Legislatures opposes federal remote sales tax legislation that does not establish parity at the point of purchase, which is necessary to level the playing field between remote sellers and in-state businesses;

BE IT FURTHER RESOLVED THAT, the National Conference of State Legislatures opposes federal remote sales tax legislation that does not establish a destination sourcing tax regime, and

BE IT FURTHER RESOLVED THAT, a copy of this resolution be sent to the President of the United States and to all of the members of the 114th Congress.

NATIONAL CONFERENCE *of* STATE LEGISLATURES

The Forum for America's Ideas

Curtis Bramble
Senate President Pro Tempore
Utah
President, NCSL

Karl Aro
Director of Administration
Department of Legislative Services
Maryland
Staff Chair, NCSL

William T. Pound
Executive Director

January 20, 2016

Dear Legislative Leader:

In 1992, the Supreme Court of the United States wrote in the *Quill* decision that "Congress can and should" address the remote sales tax collection problem. Since then, governors and state legislators have worked in good faith with Congress and have patiently waited for a federal solution, even as we watched our main street businesses and state tax collections suffer from federal inaction. We have offered solutions, including simplification of tax bases and uniformity of collection administration, and have worked to develop these solutions into bi-partisan federal legislation, the Marketplace Fairness Act (MFA) and the Remote Transactions Parity Act (RTPA). While the Senate passed MFA in 2013, the House failed to act. After over 15 years of negotiations and numerous congressional hearings, enough is enough. We cannot depend on Congress to heed the calls of their state legislative partners. It is time for the states to take action in their own legislative chambers.

The NCSL Executive Committee Task Force on State and Local Taxation (SALT) met in special session earlier this month to discuss and consider the next steps for states in light of Congressional inaction. The SALT Task Force is comprised of prominent legislative leaders and legislators in the area of tax from across the country. We discussed at length possible state legislative proposals that build and expand upon previous state legislation in order to finally bring a close to this almost two decade congressional charade.

The Task Force also heard from a leading legal expert who discussed what states should consider if they plan on challenging *Quill* and solving the issue through the federal courts. With that guidance in mind, the task force reviewed a legislative proposal that compiled the various legislative efforts into a single package. And as most every state has been considering action on this issue, we have attached the legislative package for your consideration.

The four main legislative avenues discussed were: 1) enacting legislation with the intent of ultimately accepting Supreme Court Justice Anthony Kennedy's invitation of revisiting and reversing the 1992 *Quill* decision (per *DMA v. Brohl*); 2) expanding a state's definition of nexus to capture more businesses that would be required to collect and remit applicable taxes; 3) expanding collection requirements to marketplace providers; and 4) expanding a state's reporting and registration requirements.

As a legislative leader, you understand our frustration with Congress and its unwillingness to solve this issue that is so vital to state fiscal sovereignty. We cannot go through another holiday season where sales with online merchants outpace sales on Main Street because sales taxes are not being collected. States lose billions of dollars in uncollected sales taxes each year and unless we overturn the *Quill* decision either through federal legislation or through the federal courts, sales taxes will soon become an unreliable source of revenue for state and local governments.

Should you have any comments or questions, please feel free to contact Max Behlke, (max.behlke@ncsl.org or 202.624.3586 or Neal Osten, (neal.osten@ncsl.org or 202.624.8660) in NCSL's Washington D.C. Office.

After two decades, it is time for Washington D.C. to hear our voice.

Sincerely,

Senator Curt Bramble, Utah
President, National Conference of State Legislatures

Senator Mike Gronstal, Iowa
President-elect, National Conference of State Legislatures

Senator Deb Peters, South Dakota
Vice President, National Conference of State Legislatures

Senator Debbie Smith, Nevada
Immediate Past President, National Conference of State Legislatures

Senator Pam Althoff, Illinois
Co-Chair, NCSL Task Force on State and Local Taxation

Delegate Sheila Hixson, Maryland
Co-Chair, NCSL Task Force on State and Local Taxation

Representative Chris Perone, Connecticut
Co-Chair, NCSL Task Force on State and Local Taxation

Model Legislative Proposal

I. Introduction

The attached model legislative language is a proposal for expanding sales/use tax collection requirements through state lawmaking. The proposal consists of three primary parts:

1. Nexus expansion provisions to increase the scope of state ‘doing business’ language.
2. Marketplace collection provisions to require online and other marketplaces to collect and remit sales and use tax if a retailer sells products on the marketplace.
3. Reporting provisions requiring referral marketplaces to report information.

II. Legislative Findings

Section 1 is borrowed from the draft marketplace and nexus-expansion legislation in Washington and can be used if a legislative findings section would be helpful in a state.

III. Nexus Expansion

Section 2 sets forth various provisions a state could use to expand a definition of doing business.

IV. Marketplace Collection, Remittance and/or Reporting Requirements

Sections 3 and 4 are provisions intended to ensure that sales facilitated by a variety of marketplace models are subject to tax regardless of how the sale is made. The provisions focus on two types of marketplaces.

- The first are “standard” or “traditional” marketplaces where multiple sellers sell products, sometimes the same products, on a single platform.
- The second type is a “referral” marketplace in which customers may search for products and are then referred to a place to purchase those products. Because under the referral model the marketplace provider typically has no information regarding when a sale occurs or the amount of the sale, the draft provisions do not require the marketplace provider to collect and remit but rather impose a reporting requirement with penalties.

V. Appeal

Section 5 grants a direct appeal from an assessment/deficiency notice to the State Supreme Court. This provision would need to be drafted on a case-by-case basis to ensure that the state constitution would allow such an appeal. This provision is designed to accelerate litigation over any of these provisions.

VI. Severability

This section allows an unconstitutional provision to be severed from the statute.

VII. Effective Date

The effective date should be fixed and in the future. One of the significant problems that arose during the Quill litigation that gave the justices concern was that the tax would be retroactive.

SECTION 1. LEGISLATIVE FINDINGS

The Commerce Clause of the United State Constitution as currently interpreted by the United States Supreme Court prohibits states from imposing sales or use tax collection obligations on out-of-state businesses unless the business has a substantial nexus with the taxing state.

The legislature recognizes that the United States Supreme Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) held that a person or entity must have a physical presence in the taxing state in order to find that a substantial nexus for sales and use tax collection purposes exists. The legislature finds that the reasoning of *Quill Corp. v. North Dakota* no longer applies for the reasons discussed below.

The legislature further recognizes that the Commerce Clause prohibits states from imposing a burden on interstate commerce only when it constitutes an undue burden. *See, e.g. International Harvester Co. v. Department of Treasury,* 322 U.S. 340 (1944).

The legislature finds that, due to the ready availability of sales and use tax collection software, it is no longer an undue burden for companies without a physical presence in [State] to accurately compute, collect and remit their sales and use tax obligations.

The legislature further finds that given the exponential expansion of online commerce and related technology, it is no longer an undue burden for states to require remote sellers to collect sales/use tax.

The legislature further finds the sales and use tax system established under [State] law does not pose an undue burden on out-of-state retailers and provides sufficient simplification to warrant the collection and remittance of use taxes by out-of-state retailers that are due and owing to [State] and its local jurisdictions.

Nothing in this Act may be construed as relieving in-state businesses and other businesses having substantial nexus with [State] from their [State] sales and use tax collection obligations.

SECTION 2. DEFINITION: [DOING BUSINESS/ENGAGING IN BUSINESS/MAKING RETAIL SALES/ETC.]

(A) In addition to the definitions set forth in sections [X] through [Y], ["doing business in this state"] includes the selling, leasing, or delivering in this state, or any activity in this state in connection with the selling, leasing, or delivering in this state, of tangible personal property or [taxable services] for use, storage, distribution, or consumption within this state. This subsection (A) affects the imposition, application, or collection of sales and use taxes only. ["Doing business in this state"] includes, but shall not be limited to, the following acts or methods of transacting business on a regular or systematic basis:

(1) Maintaining within this state, directly or indirectly or by an affiliate, an office, distribution facility, salesroom, warehouse, storage place, or other similar place of business, including the employment of a resident of this state who works from a home office in this state.

(2) Engaging in, either directly or indirectly through a Marketplace Provider, Referrer, or other third party, direct response marketing targeted at this state. For purposes of this [subsection], "direct response marketing" includes, but is not limited to, sending, transmitting or broadcasting of flyers, newsletters, telephone calls, targeted electronic mail, text messages, social media messages, targeted mailings; collecting, analyzing and utilizing individual data on purchasers or potential purchasers in this state; using

information or software, including cached files, cached software, or ‘cookies’ or other data tracking tools, that are stored on property in or distributed within this state; or conducting any other actions that use persons, tangible property, intangible property, digital files or information, or software in this state in an effort to enhance the probability that a person’s contacts with a customer in this state will result in a sale to that customer.

(3) Entering into one or more agreements under which a person or persons that have nexus under the Commerce Clause with this state directly or indirectly refer potential purchasers of products to the seller for a commission or other consideration, whether by an Internet-based link or an Internet web site or otherwise.

(a) The activities described in paragraph (3) of subsection (A) constitute “doing business in this state” regardless of whether or not the referral is related to the sale of tangible personal property or [taxable services].

(b) An agreement under which a seller purchases advertisements from a person or persons in this state, to be delivered on television, radio, in print, on the internet, or by any other medium, is not an agreement described in paragraph (3) of subsection (A), unless the advertisement revenue paid to the person or persons in this state consists of commissions or other consideration that is based in whole or in part upon sales of products.

(c) Paragraph (3) of subsection (A) does not apply if the seller can demonstrate that no person in this state with whom the seller has an agreement engaged in referral activity in this state on behalf of the seller that would satisfy the requirements of the Commerce

Clause. In order to qualify for the safe harbor provided by this subparagraph (A)(3)(c), the seller must:

(i) Be able to demonstrate that each in-state person with whom the seller has an agreement is prohibited from engaging in any solicitation activities in this state that refer potential customers to the seller; and

(ii) Obtain annually a certification from each such in-state person or persons that the person or persons have complied with the prohibition stated in (i) of this subparagraph (A)(3)(c). A person who intentionally or negligently provides an inaccurate certification is subject to the penalties set forth under [Insert applicable penalty section from statute.]

(B) A seller is also doing business in this state if any part of the sale process, including listing products for sale, soliciting, branding products, selling products, processing orders, fulfilling orders, providing customer service or accepting or assisting with returns or exchanges occurs in the state, regardless of whether that part of the process has been subcontracted to an affiliate or third party. The sale process does not include shipping via a common carrier.

(C) The seller offers its products for sale through one or more marketplaces operated by any Marketplace Provider that has substantial nexus with this state.

(D) A seller is presumed to be doing business in this state if the total cumulative sales price of products sold to purchasers in this state exceeds [$XXX] in the immediately preceding calendar year. The seller is required to collect and remit sales and use tax unless it can prove that it does not have nexus with this state under the Commerce Clause.

[***Alternative – Streamlined*** – (D) A seller is presumed to be doing business in this state if the total cumulative sales price of products sold to purchasers in this state exceeds [$XXX] in the immediately preceding calendar year and the seller either has physical presence in or is registered to collect and remit sales tax in a state that is a member of the Streamlined Sales and Use Tax Agreement. The seller is required to collect and remit sales and use tax unless it can prove that it does not have nexus under the Commerce Clause with this state.]

(E) A person is also presumed to be doing business in this state if such person is related to a person that has nexus under the Commerce Clause with this state, and such related person:

(1) Sells under the same or a similar business name tangible personal property or [taxable services] similar to that sold by the person against whom the presumption is asserted;

(2) Maintains an office, distribution facility, salesroom, warehouse, storage place, or other similar place of business in this state to facilitate the delivery of tangible personal property or [taxable services] sold by the person against whom the presumption is asserted to such person's in-state customers;

(3) Uses, with consent or knowledge of the person against whom the presumption is asserted, trademarks, service marks, or trade names in this state that are the same or substantially similar to those used by the person against whom the presumption is asserted;

(4) Delivers, installs, or assembles tangible personal property in this state, or performs maintenance or repair services on tangible personal property in this state, which

tangible personal property is sold to in-state customers by the person against whom the presumption is asserted; or

(5) Facilitates the delivery of tangible personal property to in-state customers of the person against whom the presumption is asserted by allowing such customers to pick up tangible personal property sold by such person at an office, distribution facility, salesroom, warehouse, storage place, or other similar place of business maintained in this state.

(6) Shares management, business systems, business practices, or employees with the person against whom the presumption is asserted, or engages in intercompany transactions with the person against whom the presumption is asserted related to the activities that establish or maintain the market in this state of the person against whom the presumption is asserted;

(7) For purposes of this subsection (D), two persons are related if

(a) such persons are related to the remote seller within the meaning of subsections (b) and (c) of section 267 or section 707(b)(1) of the Internal Revenue Code of 1986; or

(b) such persons have 1 or more ownership relationships and such relationships were designed with a principal purpose of avoiding the application of this section.

(8) The presumption set forth in this subsection (D) may be rebutted by a preponderance of evidence that, during the taxable period in question, the related person with nexus under the Commerce Clause did not engage in any activities in this state that are sufficient under the Commerce Clause to establish nexus in this state on behalf of the person against whom the presumption is asserted.

(F) A Marketplace Provider or a Referrer is subject to this state's sales and use tax jurisdiction if it performs any of the activities described in paragraphs (A) – (D) of this section.

SECTION 3. IMPOSITION OF TAX ON MARKETPLACE PROVIDERS

(A) Marketplace Provider. The term "Marketplace Provider" includes any person who facilitates a [retail sale/sale] by a [retailer]. For purposes of this [Chapter], a Marketplace Provider facilitates a [retail sale/sale] when the Marketplace Provider both (i) lists or advertises [tangible personal property and services] for sale in any forum, including a catalog or Internet website, and, (ii) either directly or indirectly through agreements or arrangements with third parties, collects [receipts] from the customer and transmits those [receipts] to the Marketplace Seller, whether or not the Marketplace Provider deducts any fees from the transmission of those [receipts] to the Marketplace Seller. The [Department of Revenue] may promulgate regulations that further clarify when a Marketplace Provider facilitates a [retail sale/sale].

(B) Marketplace Seller. A [seller/vendor/retailer] that has any sales facilitated by a Marketplace Provider.

(C) A Marketplace Provider [doing business in the state under Section 2] is required to [collect and remit/pay] the [sales and use tax] on any sales facilitated by the Marketplace Provider to customers in this state. However, no Marketplace Provider is required to [collect and remit/pay] sales or use tax on a sale from a Marketplace Seller to a customer in this state if the Marketplace Seller either (i) provides a copy of the [retailer's] registration to collect sales and use tax in this state to the Marketplace Provider before the Marketplace Provider facilitates on that sale or (ii) the Marketplace

Seller appears on a list published by the [Department of Revenue] of the entities registered to collect sales and use tax in this state. The [Department of Revenue] shall promulgate regulations regarding the content and publication of the list. Nothing in this Section shall be construed to interfere with the ability of a Marketplace Provider and a Marketplace Seller to enter into agreements with each other regarding fulfillment of the requirements of this [Chapter].

(D) A Marketplace Provider is relieved of liability under this [section] for failure to collect and remit the correct amount of the tax to the extent that the Marketplace Provider can demonstrate that the error was due to incorrect information given to the Marketplace Provider by the Marketplace Seller. Provided, however, this [subsection] shall not apply if the Marketplace Provider and the Marketplace Seller are related as defined in [Section 2].

SECTION 4. REFERRER REPORTING AND REGISTRATION REQUIREMENTS

(A). Referrer. The term "Referrer" shall mean every person who (i) contracts or otherwise agrees with a [retailer] to list multiple items of [tangible personal property and services] for sale and the sales price of those items in any forum, including a catalog or Internet website, (ii) receives a fee, commission, or other consideration from a [retailer] for the listing, (iii) transfers, via telephone, Internet link, or otherwise, a customer to the [retailer] or the [retailer's] website to complete a purchase and (iv) does not collect receipts from the customer for the transaction.

(B) Referrer Permit.

(1) By the first day of the last month of a calendar year, every Referrer that received more than $10,000 in fees paid by [retailers] for the services described in [Section 4(A)]

in the previous calendar year, or that received more than $7,500 for such services in the first three quarters of the current calendar year, must file with the [Department of Revenue] a notice, in a form prescribed by the [Department of Revenue], stating the Referrer's intent to provide the services set forth in [Section 4(A)] in the following calendar year.

(2) The [Department of Revenue] shall, within 15 days of receipt of the notice, issue a permit to such Referrer, without charge, to provide such services to [retailers] to refer customers in this state to [retailers].

(3) A Referrer required to file the notice set forth in this subdivision that fails to obtain a permit shall not refer customers in this State to [retailers]. A Referrer that does so without a permit shall be required to pay the fee described in [Section 4(D)].

(C) Referrer Information Reporting.

(1) In addition to any other return or report required to be filed under this [Chapter], a Referrer that receives more than $10,000 in fees paid by [retailers] for the activities described in [Section 4(A)] of this [Chapter] in the previous calendar year is required to file a report annually listing the following:

(i) The name and address of each [retailer] who has contracted with the Referrer to refer customers within this state to the [retailer].

(ii) If available, the cumulative sales price and any available transactional-level detail for referrals made by the Referrer of customers in this state to each [retailer], including listed price of items and the number of times referrals were made to [retailers] for those items. The Referrer shall not be required to provide any information that could identify a purchaser.

(iii) If available, the number of potential customers located in this state that were referred to the [retailer] and if available, the number of customers who made purchases after a referral.

(2) A Referrer that receives more than $10,000 from fees paid by [retailers] during the previous calendar year is also required to provide notice to [retailers] that the [retailer's] sales may be subject to sales and use tax and that the [retailer's] contact information and sales volume into this state is being provided to the [Department of Revenue]. The [Department of Revenue] may establish by regulation what constitutes notice to [retailers] sufficient to meet the requirements of this subdivision.

(3) If a Referrer does not meet the requirements of subdivision (1) or (2) such Referrer shall have its permit issued under [Section 4(B)] revoked.

(4) A Referrer is not required to provide the information under paragraph 1 of this subdivision for a [retailer] if the [retailer] either (i) provides a copy of the [retailer's] registration to collect sales and use tax in this state to the Referrer or (ii) the [retailer] appears on a list published by the [Department of Revenue]. The [Department of Revenue] shall promulgate regulations regarding the content and publication of the list.

(5) A Referrer is not required to provide the information under paragraph 1 of this subdivision if the Referrer is a Marketplace Provider that collects and remits sales and use tax under [Section 3].

(D) Tax. When a Referrer as defined in [Section 4(A)] refers a customer to a [retailer] and the [retailer] makes a [retail sale] to that customer in this State, liability for the sales and use tax on the transaction due from the [customer/seller] is imposed on the Referrer in the amount of the sales and use tax that would have been due on the transaction, based on the sales price listed by the Referrer or [retailer], unless the [retailer] either (i) provides a copy of the [retailer's] registration to collect sales and use tax in this state to the Referrer or (ii) the [retailer] appears on a list published by the [Department of Revenue] of the entities registered to collect sales and use tax in this state. The [Department of Revenue] shall promulgate regulations regarding the content and publication of the list. This [subsection] shall not apply to any Referrer that has complied with [subsections (B) and (C)] of this [Section].

SECTION 5. APPEAL

Notwithstanding any section of law to the contrary, if the [tax commissioner] issues one or more [final determinations under section [ ], any appeal may be made directly to the [supreme court] within [sixty days] after the date the [commissioner] issued the [determination] if the primary issue raised by the [petitioner] is the constitutionality of [Sections 2, 3 or 4.]

SECTION 6. SEVERABILITY

If any provision of [these Sections] or the application thereof is held invalid, such invalidity shall not affect the provisions or applications of [these Sections] which can be given effect without the invalid provisions or applications.

SECTION 7. EFFECTIVE DATE

These provisions shall apply to tax years beginning on or after [January 1, 2016].

Summary and Recommendations

The final task for the Ohio 2020 Tax Policy Study Commission was to provide recommendations for moving Ohio to a flat tax of either three percent or three and a half percent. Throughout all of the testimony included in this report, there is a clear trend that while potentially beneficial, a transition to a flat tax is challenging with the amount of tax credits and expenditures that are currently available. Ohio forgoes over $7 billion annually in revenue through more than 120 specific exemptions that are currently in the Ohio Revised Code.

In testimony heard by the committee on November 19, 2015, Richard Vedder, Distinguished Professor of Economic Emeritus at Ohio University, testified that flat and low income tax rates generally support economic growth; however, it is difficult to achieve those tax rates with so many credits and deductions eroding the tax base. When asked how Ohio should handle a transition from a complex tax system to a flat tax, Dr. Vedder stated that a flat tax can only be adopted when the state has a surplus of revenue available, when unemployment is low, and when there are no crises going on in the state. A substantial amount of state revenues would have to be dedicated to lowering the tax to three percent.

In testimony on November 19, 2015, Albert Macre from Albert F. Macre & Co. Certified Public Accountants suggested that the Commission review the tax credits and expenditures if moving towards a flat tax is considered.

In testimony on February 24, 2016, The Buckeye Institute discussed their support for moving to a broader, more flat tax rate; however, in order to do so, the number of tax credits and expenditures need to be considered.

In testimony on February 24, 2016, the Ohio Manufacturers' Association articulated their concerns with the amount of tax credits and expenditures and the effect that these have on the tax base as a whole. They recommend that these items should be reviewed to determine what may be eliminated and then work towards a broader tax system that is fair for all taxpayers.

In testimony on June 20, 2016, The Ohio Society of CPAs stated that although moving to a flat tax rate would be simpler, they discussed concerns with the financial challenges that this could cause during tough economic times, and whether or not moving to a flat tax would be supplemented with increasing other taxes or adding sales taxes on new services. The testimony also mentions the need for a review of tax credits and deductions to help provide additional revenue to offset any changes made to the income tax rates.

In testimony on September 26, 2016, Policy Matters Ohio recommended against moving to a flat income tax due to the impact this could have on low-income Ohioans, and stated their preference for simplifying the tax system by eliminating unnecessary tax credits and expenditures.

In testimony on October 31, 2016, One Ohio Now indicated opposition to moving toward a flat tax, and suggested reviewing the tax expenditures and credits as a way to make Ohio's revenue system fairer.

The recent enactment of House Bill 9 (Boose – 131st General Assembly), which created the Tax Expenditure Review Committee to review all tax credits and expenditures, will provide the opportunity for the thorough review that was referenced by those testifying before the Commission. This committee is comprised of six legislators and the Tax Commissioner. HB 9 passed unanimously in both the House and the Senate and became effective on March 21, 2017.

Much of the responsibilities of this new committee tie in to the goals set forward for the final phase of the Ohio 2020 Tax Policy Study Commission, and will continue to be reviewed in this newly created committee. The purpose of HB 9 is to establish a formal structure to conduct cost-benefit analyses of Ohio's tax expenditures and provide recommendations for their improvement.

As stated throughout the testimony heard by the Commission and provided in this report, in order to implement a flat tax, the tax credits and expenditures need to be thoroughly reviewed to determine which ones can be eliminated or modified to free up some of the revenue needed to lower the rate. Although the Ohio 2020 Tax Policy Study Commission heard testimony on the tax credits and expenditures, a more thorough review is needed, and is required as part of the permanent Tax Expenditure Review Committee.